Bulgaria Microfinance Assessment

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Bulgaria
ROMANIA
YUGOSLAVIA
F.Y.R. MACEDONIA
MACEDONIA
GREECE
TURKEY
THRACE
DOBRUJA
Black Sea
Aegean Sea
Sea of Marmara
Bosporus
Burgas Bay
Nos Kaliakra
Balkan Mountains
Rhodope Mts.
Danube
Iskŭr
Osŭm
Yantra
Kamchiya
Maritsa
Struma
Mesta
Arda
Inece
Sofia
Plovdiv
Varna
Burgas
Ruse
Pleven
Sliven
Vidin
Lom
Kozloduy
Brusartsi
Oryakhovo
Nikopol
Svishtov
Knezha
Byala Stalina
Montana
Berkovitsa
Vratsa
Lukovit
Lovech
Levski
Byala
Sevlievo
Troyan
Botevgrad
Gabrovo
Karlovo
Pernik
Radomir
Panagyurishte
Ikhtiman
Samokov
Musala 9,596 ft. (2,925 m)
Kyustendil
Blagoevgrad
Pazardzhik
Rakovski
Stara Zagora
Gŭlŭbovo
Dimitrovgrad
Khaskovo
Kharmanli
Svilengrad
Kŭrdzhali
Momchilgrad
Madan
Smolyan
Sandanski
Petrich
Silistra
Kubrat
Dulovo
Isperikh
Tervel
Dobrich
Razgrad
Popovo
Tŭrgovishte
Veliko Tŭrnovo
Tryavna
Shumen
Novi Pazar
Balchik
Kavarna
Shabla
Smyadovo
Byala
Aytos
Karnobat
Pomorie
Yambol
Radnevo
Elkhovo
Sredets
Primorsko
Tsarevo
Malko Tŭrnovo
Field Review Site
Field Review Site
Field Review Site
22° E
24° E
26° E
28° E
44° N
42° N
0 50 Miles
0 50 Kilometers
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ACRONYMS

BACB	**Bulgarian American Credit Bank**
BAEF	**Bulgarian American Enterprise Fund**
BC	**Business Centers**
BGL	**Bulgarian leva**
BNB	**Bulgarian National Bank**
CAMEL	**Capital, Assets, Management, Earnings, Liquidity**
CEO	**Chief Executive Officer**
CRS	**Catholic Relief Services**
DRI	**Danube River Initiative**
EBRD	**European Bank For Reconstruction and Development**
EU	**European Union**
GOB	**Government of Bulgaria**
IFC	**International Finance Corporation**
JOBS	**Job Opportunities through Business Support**
LIP	**Local Initiatives Project**
MFI	**Micro Finance Institution**
NATO	**North Atlantic Treaty Organization**
NBFI	**Nonbank Financial Institution**
NGO	**Nongovernmental organization**
OI	**Opportunity International**
PEARLS	**Protection, Effective Financial Structure, Asset Quality, Rates of Return and Costs, Liquidity and Signs of Growth**
PMRC	**Private Mutual Rural Credit Associations**
SSB	**State Savings Bank**
SME	**Small and medium enterprise**
SEDF	**Soros Economic Development Fund**
SWOT	**Strengths, Weaknesses, Opportunities and Threats**
TOR	**Terms of Reference**
UBB	**United Bulgarian Bank**
UNDP	**United Nations Development Program**
USAID	**United States Agency for International Development**
USTOI	**Bulgarian for support**
WOCCU	**World Council of Credit Unions**

Executive Summary

At the request of USAID, The Peoples Group Team visited Bulgaria from February 18 to March 6, 2002, to assess the three USAID-supported microfinance programs. The Team found that these young programs have made substantial progress in less than three years and represent a positive development in the Bulgarian financial system. The Team recommends providing additional support to these programs for a period of one-to-two years, until they can achieve sustainability. Further, the Team recommends that USAID take the initiative in assisting the Bulgarian government to establish a system through which appropriate oversight can be provided to these and other non-bank financial institutions (NBFIs) on an ongoing basis.

Microfinance in a Broader Context

Microfinance and small and medium enterprise (SME) financing programs in Bulgaria are responses to the need for financial products and services that are either not being provided by commercial banks or are only available on terms that are difficult for borrowers to meet. There are many reasons that commercial banks have largely declined to enter this market. For the past decade, commercial banks (both state and privately owned) have undergone significant restructuring. The first five years witnessed two major banking crises. These crises resulted largely from government policies and interventions and unsound banking practices. The second five years has been a period of recovery, legal reform, privatization, rejuvenation, and growth. For the most part, the most recent five-year period has witnessed the development of appropriate Government of Bulgaria (GOB) policies regarding regulation, examination, and supervision of commercial banks consistent with international banking practices.

Today, with the assistance of international financial institutions and the donor community, all but the State Savings Bank (SSB) and Biochim Bank have been privatized. The Bulgarian National Bank (BNB) has developed a credible bank supervisory system staffed with professionals. Nevertheless, a healthy financial system does not emerge overnight. Weak commercial banks take months and years to see the results of stricter adherence to sound banking practices impact positively on the bank's bottom line and the communities' economic growth. Businesses also take time to learn that sound business practices, a good profit picture, and operational performance are needed to encourage a rejuvenated commercial bank to lend to their enterprise. Understandably, commercial banks struggling to develop the proper banking formula to assure safety, while expanding lending to the broad Bulgarian business community, will be reluctant to develop products and lend to the micro and SME borrowers. Commercial banks are not well organized to make large numbers of small loans to individuals and very small businesses, and their attempts to learn how often become expensive or result in dismal failure.

To serve this market, which has been largely ignored by the commercial banks, institutions and programs sprang to life, including the popular banks or kasas, which were built on institutions established during the communist era, the European Union (EU) program to establish private credit cooperatives, and micro and SME lending programs like those evaluated here or developed by other donors and nongovernmental organizations (NGOs). These non-bank financial institutions (NBFIs) have proved themselves better suited than the commercial banks to serving very small borrowers. They develop methods and approaches that enable them to serve a large number of small borrowers effectively and efficiently. Because Bulgarian law requires a cooperative form of organization for these financial institutions to operate, their customers are represented on the boards of directors, which helps further focus management on serving their niche market customers.

On the regulatory side, the BNB Bank Supervision Unit is reluctant to engage these NBFIs in a bank supervisory program. BNB believes that regulating and examining these small NBFIs, which have so many small loans, would be a waste of bank supervisory resources, especially in view of the fact that the NBFIs have a negligible impact on the nation's banking system. From their standpoint, they are correct. The BNB does not have the systems available to monitor and regulate the NBFIs efficiently. However, to leave NBFIs unregulated and unsupervised would be a mistake. Their failure would have a systemic impact on the customers they serve. The public would hold BNB responsible regardless of any formal requirement regarding BNB supervision. Development of appropriate monitoring and regulatory systems without excessive use of BNB staff time can and should be undertaken.

In fact, the operating authority of these programs is limited and dependent upon donor support. Unless they are given permanent corporate status in The Banking Act[1], they may not survive when their supporting donor agreements with the GOB expire. This is the background against which the USAID sponsored programs are operating and thriving.

USAID's Thriving Microfinance Programs

Nachala, Catholic Relief Services (CRS), and World Council of Credit Unions (WOCCU)—the three USAID sponsored programs assessed in this report—have each performed a very credible job in developing a sound microfinance program. At 2001 yearend, the three programs combined had 6,000 active borrowers and project a 200%+ increase in borrowers during the next 4 years, depending on available funding. Women are obtaining nearly 50% of the loans. As a direct result of the lending, approximately 3,000 jobs were created in 2001. More must be done, however, if each of these programs is to result in a sustainable financial institution.

Loans of the three programs are used to finance micro and small business operations, consumer purchases, education of children, and the purchase of land, facilities, and equipment. Though many of the latter activities would normally require longer-term amortization of five to ten years, these programs currently require loans to be repaid in less than one year. Borrowers manage to comply, resulting in fairly low loan delinquency.

The reasons for high repayment rate are several. The programs know their borrowers well and carefully select those to whom they lend money. Many more borrowers exist than institutions or funds, so if a borrower does not repay, he or she is not likely to obtain another loan. Group borrowing as well as joint and several liability clauses encourage prompt repayment. Borrowers are encouraged to repay by the fact that if they do so, they will receive future loans. It is likely

[1] We recommend that The Banking Act and its designated regulator, the BNB, be the complete statutory and regulatory authority over financial institutions operating in Bulgaria.

that if an announcement were made that the programs were to be phased out, the repayment percentages would decline rapidly. In effect, programmatic success to date is fragile unless these institutions reach sustainability.

The total loan portfolios of the three USAID sponsored programs have reached $4 million USD, with an average size loan of about $950 USD. USAID has managed to achieve this level of loan growth with just $2 million in loan capital, a modest investment for this result. The three programs are now projecting loan growth for 2002 ranging from 42% to 71%, a strong performance, if achieved.

The success of USAID and other donor microfinance and NBFI lending programs is demonstrated by the gradually increasing interest of some commercial banks in entering the micro and SME market. Though bank collateral demand in excess of 200% of the loan amount and the frequent requirement of multiple guarantees is not unusual, banks are still not doing any significant lending below $20,000. Nevertheless, a few lenders with donor funds and some government guarantees are beginning to do micro and SME lending, though these programs remain small. The GOB recently established through the Ministry of Labor a micro lending program intermediated through three commercial banks. As this program has only recently started, it is too early for results.

The ProCredit Bank has recently opened as a microfinance bank with EBRD and foreign commercial and institution support. It is off to a fast start with loans tailored for both the SME and micro borrower with reasonable loan terms and maturities tailored to the borrowers' activities. This is a small but important indication that the USAID microfinance programs have encouraged the banking community to consider micro and SME lending as a potentially profitable banking business.

In sum, the USAID sponsored microfinance programs have demonstrated that micro and SME lending can be conducted safely and profitably in Bulgaria. The numbers and types of borrowers being served shows that the programs are providing important financial products and services to the community—the only such access that most of their customers have. The high level of loan growth waiting to be funded shows that this banking niche has much more potential and that one or more of the programs may achieve sustainability if allowed to build its portfolio. The interest of some commercial bank suggests the micro and SME lending is about to become more competitive and more a part of mainstream banking in Bulgaria.

Recommendations Regarding Next Steps for USAID

What is to be done to ensure that these important experiments that have demonstrated their worth become sustainable and have the ability to continue to operate? Where should USAID go from here?

1. **Provide Continuing Financial Support**

USAID should continue to give financial support to these microfinance programs to allow them to become sustainable or until their loan portfolios are absorbed into a sustainable institution. These institutions have substantial numbers of customers who should not be suddenly left without alternative financial services. The loan demand is there and these institutions by and large use methods and approaches through which they lend safely and profitably. Based on the progress of the three microfinance programs over the past three years, it seems reasonable to expect that with modest additional support, all three can achieve sustainability within a time frame normally expected in similar USAID-supported programs around the world.

Everyone recognizes that start-up subsidized support or seed capital must end at some point and that these institutions must operate on their own resources. The USAID supported institutions and programs are not yet at that point. They require continued support for one-to-two additional years to reach the size and strength to be sustainable. Those institutions not able to achieve sustainable growth within this period should be encouraged and assisted to merge with other sustainable institutions, including commercial banks, so that their customer base is not suddenly dropped and adversely economically impacted.

If USAID has funding reductions and is unable to continue funding to all programs, then we recommend that USAID funding be concentrated on the best performing institution, which in the opinion of the Team is Nachala. USAID should continue technical assistance and training support to demonstrate to other donors and lenders that growth of management expertise, board development, and maintenance of internal controls will continue. If USAID funding is not available to continue, then USAID should assist the NGOs to obtain donor and debt funding from other sources or assist the consolidation of the portfolios. Alternatively, USAID should assist the programs to consolidate to develop a sustainable institution from the combined portfolios. The primary point here is focusing on making sure that the programs' customers have a continuing source of reliable financing and that these programs do not simply disappear as a multiyear experiment with no graduation, sustainability, or exit strategy.

2. Help Establish a Legal and Regulatory Framework

USAID should take a lead role in providing technical assistance to the GOB through the BNB to enable a legal and regulatory framework to be established so that NBFIs have a long-term regulator and supervisor. This regulator would address and resolve financial crises and deal with inappropriate management practices that inevitably occur from time to time in all financial institutions. Currently, the NGOs managing the microfinance programs serve as both nurturer and supervisor, keeping the programs operating on a safe and sound basis. When their support ends, there must be some residual body overseeing operation of these microfinance institutions to protect the interests of the customers and communities that they serve. This is a delicate issue because the GOB and the BNB must agree on the value of this effort.

An NGO regulator can be established, funded by assessments of institutions served, which both regulates and supervises them under the ultimate authority of the BNB. This enables institutional supervision without unnecessarily straining or involving the BNB staff or resources. Leaving an appropriate legal and regulatory framework behind for these NBFIs, which have demonstrated their value to the Bulgarian community, would be the next logical step to assist the appropriate evolution of the Bulgarian financial sector.

I. Project Description

A. Background

In September 1999, USAID/Bulgaria initiated a program to support three microfinance activities, as an immediate response to the Kosovo crisis. The rationale for this support was to increase income and employment on a sustainable basis among low-income groups and communities throughout Bulgaria, with a particular focus in the Danube River region—one of the most affected regions in the country. These microfinance programs were oriented toward increasing the number of micro-business entrepreneurs and providing additional support and better access to alternative financial services for micro enterprises and SMEs in the country.

USAID requested that an assessment of the progress of these programs be carried and engaged The Peoples Group, Ltd. The fieldwork was carried out during the period February 18 through March 6, 2002.[2] The TOR indicated that the overall objective of the assessment was to weigh the applicability of various microlending activities in the context of the Bulgarian environment. Also, it was to provide USAID/Bulgaria with concise information on the most current trends and prospects for future programming.

B. Overview of Bulgarian Banking and the Advent of Microfinance Institutions

Microfinance in Bulgaria must be put in the context of the evolution of Bulgarian banking during the past decade and its more current financial health. The Bulgarian banking industry has been transitioning to a market economy. During the past ten years, however, Bulgarian banks have had a number of difficult periods.

During late 1989, Bulgaria entered a financial crisis due to its inability to make payments on its foreign debt. In March 1990, the GOB defaulted on its foreign debt causing suspension of all international commercial bank lending. In partial response to the 1990 financial crisis, the GOB restructured its centrally planned banking system into a two-tiered system. The old communist bloc style system consisted of a series of specialized banks:

- the BNB with branches throughout the country acting as a commercial bank;
- the individual savings system consisting of the State Savings Bank and the system of post office accounts, which took deposits from individuals and provided liquidity funding to the government;
- the Foreign Trade Bank (later Bulbank) handling all international banking, foreign currency, and trade transactions; and

[2] Detailed information on the Assessment objectives, methodology and composition of The Peoples Group Team can be found at Appendix F.

- a series of three sector banks--Biochim Bank, Mineralbank, and the Construction Stroi Bank--that channeled government budgetary funds to specific economic sectors.

Following the foreign debt default, the government instituted reforms and adopted a two-tiered system. The BNB was converted into a "true" central bank with traditional central money supply management and bank supervisory functions. The BNB branches were devolved into individual banks. Each of these branches and the sector banks were then chartered by the BNB as commercial banks, with corporate charters authorized to issue shares as other corporations, though only to the national and local government bodies.

These newly chartered commercial banks were in a weakened financial state. Their capital was inadequate to support their loan portfolios and severely inadequate when loan quality was taken into account. With too few banking opportunities, these banks developed their loan portfolio by continuing what their managers had done in the past and lent money to SOEs, and thereby added a new layer of non-performing loans to their inherited bad loan portfolio. The banks were encouraged or even directed by government officials to provide these loans. With these non-performing loan portfolios, many banks were technically insolvent, but the government kept the banks operational with sufficient liquidity from various government sources. By 1992, the Bulgaria authorities realized the need to consolidate the banks into a smaller number of larger banks and recapitalize them. Only then, could the government proceed to privatize these state-owned banks.

In 1992, the GOB established a holding company, the Bank Consolidation Corporation (BCC), to hold all shares of the state owned banks, except for the SSB, to facilitate consolidation and privatization of these banks. The BCC staff operating under the supervision of the BNB developed a bank consolidation plan for reducing the numbers of banks. United Bulgarian Bank (UBB) resulted from the consolidation of Construction bank and 21 former BNB branches. Expressbank in Varna and Hebrosbank in Plovdiv were the consolidations of other former BNB branches.

The BCC only partially restructured the banks portfolios and left them technical insolvent after the cleanup program was finished. Rather than finish the needed restructuring, the GOB chose to keep the banks operating with liquidity, through the management of government funds and from loans from the BNB and SSB. While this practice can keep a bank operational for as long as additional liquidity is provided, a bank's losses from non-performing loans will continue to increase widening the insolvency. In this early period of 1992-94, the government only talked of privatization, allowing only the UBB and a few smaller banks to be partially privatized through minority interests to private foreign investors or the EBRD.

Once again, in a weakened financial state, these “restructured” banks found it difficult to conduct quality commercial banking activities. The GOB did not take any restructuring measures to reduce the likelihood that bankruptcies would recur. Compounding the problem, some loans were still being made to failing SOEs that the government felt that it could not afford to close due to the high numbers of employees that would be made redundant. The management and loan officers of several of these state owned banks tried to learn new banking skills and participated in bank training programs provided by the international donor community. Directors, owners, SOEs, and government officials still forced large numbers of loans to be made without regard to sound banking practices or to repayment to insiders, their relatives, their associates, and their affiliates. The GOB continued to advance funds to paper over these non-performing loans and keep the banks afloat rather than solve the basic problems, but the real losses grew. Bulgaria's second banking crisis erupted in early 1996, as the GOB could no longer cover the banks' huge losses. By mid-year 1996, a financial crisis turned into a liquidity crisis with banks unable to satisfy the depositors' demand for funds withdrawal. All but the SSB closed their doors. The Bulgarian public will take a long time to forget their inability to access their deposits. Public confidence in commercial banks dropped to an all time low.

The banking laws were amended to correct a lot of past abuses—insider self-dealing, conflicts of interest, and other similar managerial abuses. New BNB regulations covered capital adequacy, deposit insurance, payments settlement, foreign currency transactions, insider lending, government securities trading, risk evaluation, internal controls, and liquidity management, to name a few. The BNB gained greater control over approving substantial changes in ownership to restrict inappropriate people from becoming major bank shareholders. Other improvements focused on the safety and soundness of a bank requiring greater capital, stronger reserves, and greater liquidity. The BNB received stronger powers to place an insolvent bank under conservatorship or in liquidation. In short, Bulgaria reformed its banking laws to foster sound banking practices with a stronger regulatory supervisor to help maintain safe and sound banking operations. Then began the process of building a modern, effective bank supervision staff.

A new government sought the aid of the International Monetary Fund (IMF), which responded with a good financial package for supporting the financial system but at the price of a long list of economic policy reform measures. Central to these was the establishment of a currency board to peg the lev to the German Deutsche mark. The BCC had to close and liquidate insolvent private banks and to restructure the state banks and privatize them. From the inception of the currency board, the Bulgarian lev stabilized rapidly lowering inflation and real interest rates.

It was this financial stability that enabled microfinance institutions (MFI) and other NBFIs to start developing and grow. With a more stable economy, average citizens saw the ability to put money to work in a small business to give them a chance for gainful employment and build an economic future. Others saw the chance to afford a variety of consumer items—stoves, refrigerators, televisions, cars, and house and apartment renovations. Demands for loans grew as people felt more comfortable that they could repay them. In a sense, the second financial crisis and public fear and anger over the banks closing their doors gave rise to allowing NBFIs to organize and develop.

Efforts to make serious efforts to rejuvenate the popular banks of the last century, to establish credit cooperatives under the EU PHARE program, and to develop microfinance programs began with the GOB in 1993, but little progress was made toward actual organization and implementation. Of the three USAID sponsored programs, Nachala was first organized as a foundation in 1993 to begin small lending programs. The EU PHARE credit cooperatives pioneered the effort starting their program in 1995. Yet, it was not until the new government was installed after the second 1996 financial crisis that the GOB agreed to allow microfinance programs and the establishment of NBFIs to administer them notwithstanding the banking reforms generally restricting lending to commercial banks. The EU PHARE program gained the right to lend as credit cooperatives as an exception to the banking law reforms in 1997 enabling them to start lending in early 1998. The other programs followed the EU PHARE program lead and organized themselves as cooperatives to take advantage of the credit cooperatives exemption and GOB memoranda of understanding with their donor sponsors. Nachala re-established itself as a foundation in 1997 and begin operations starting in 1998. Shortly thereafter, WOCCU began its technical assistance program for the kasas and CRS began a microfinance group-lending program through USTOI. The performance of these programs is discussed in greater detail below.

Most significant to the programs' long term sustainability is their legal and regulatory limbo—they can operate and make micro and SME loans from donor and other funds for now. However, they are not regulated by the BNB, and they are not allowed to take deposits except from their members in the form of capital that could be re-loaned. And despite the exception to The Banking Act that allows the cooperatively established MFIs to operate, their effective ability to continue probably expires with the ending of their donor programs unless their full and complete legal and regulatory status is resolved. The GOB should resolve their legal status to allow continued access to the public—consumers, sole proprietor, and small businesses—for financial services that the commercial banking sector is unable or unwilling to provide.

The importance of the financial services the NBFIs provide to a wide range of customers is increasingly demonstrated with growing loan portfolios and client lists. Demand is outstripping supply of loanable funds. Funding sources from international financial institutions (World Bank Group, EBRD, and European development banks) is available, but they would all like to see that these institutions gain a stable legal framework and appropriate regulatory oversight before they commit substantial additional capital to fund their loan growth.

Commercial banks will not be seriously developing the micro and SME market soon. The Bulgarian commercial banking industry is in its early stages of developing prudential banking operations within the confines of a modern legal, regulatory, and supervisory framework. They are also adjusting to their foreign bank owners that purchased the privatized state banks. The banking industry has been slowly reentering the lending market under a restrictive, conservative framework, financing only the best businesses and projects. With very few exceptions, commercial banks are avoiding the consumer and small business market for financial services. For the last three years, most Bulgarian banks have relatively high liquidity for commercial banks. At yearend 2001, Bulgarian banks on a consolidated basis had secondary liquidity ratio, including cash, cash equivalents, and government securities, of nearly 60 percent. Banks have been building liquidity since the 1996 financial crisis.

The financial crisis taught the banks that they must learn to walk before they run full service banking and lending operations. They have built up their liquidity to support their depository base, built up their capital to meet the higher minimum capital requirements. Bank managers are focused on maintaining good operations with a minimum of losses first, to avoid being replaced by the new foreign owners. Recently, keeping assets in cash limits the risk of bank losses. That cash has been placed more profitably and safely in liquidity instruments in Germany, Austria, and Switzerland than in investing in loans in Bulgarian businesses. Management knows that maintaining assets in cash or the equivalent is fine for safety and security, but this approach leaves a bank with low profitability. Management must develop sound lending programs to put their assets to work within the BNB supervisory framework. Most are trying to do just that—some even with micro and SME lending.

The BNB has been busy, with the able assistance of USAID sponsored bank supervisory experts, developing a sound bank regulatory, examination, and supervisory capability to provide appropriate prudential oversight to this restructured banking system. The BNB does not have the funds, or the staff to add the NBFIs to their portfolio of institutions to regulate. Consequently, the BNB adamantly opposes any added regulatory responsibilities. As this evaluation of the program demonstrates, microfinance and SME lending provides valuable financial services to their growing customer base and should not be cavalierly ended. Legal, regulatory, and supervisory issues can be addressed adequately through an NGO regulator supported by assessments of the NBFIs regulated under the direct ultimate control of the BNB. More on this approach is detailed below.

II. Review of USAID Supported Microfinance Organizations

Below is a summary description of each of the three USAID-supported NGO programs, with particular attention to their loan and portfolio characteristics.

A. USTOI (Supported by Catholic Relief Services)

1. Description of the Program

USTOI is a Bulgarian word meaning "support." The mission of USTOI is to increase income and employment of micro-entrepreneurs in Bulgaria. USTOI supports micro-business development by providing entrepreneurs with access to financial services. The USTOI Microfinance program is being implemented with support from Catholic Relief Services (CRS) – Bulgaria.

The USTOI program works with clients in three major cities and surrounding areas: Stara Zagora, Pleven and Veliko Tarnovo. The USTOI program extends credits through cooperative structures. Cooperatives are registered in each program site and borrowers are cooperative members.

2. Description of Operations

In order to apply for credit from USTOI, borrowers must:

- Have a functioning business in trade, services or the small-scale production sector;
- Have fixed assets below $5,000;
- Carry out activities as a sole proprietor or other company with no more than 3 employees, including family members;
- Carry out activities in their home or in rented premises; and
- Must earn secure year-round incomes from other business activities, if they are agricultural producers.

USTOI does only group lending. In order to obtain loans from USTOI, entrepreneurs must set up a guarantee group with no less than 7 members. Group members mutually guarantee loans that they receive from USTOI. The membership of the group is established independently by the clients and not by the employees of USTOI. The intention is that each group will be formed of people who have substantial mutual trust and solidarity. The members of each guarantee group also become members of the USTOI cooperative that is registered in the respective region.

Product characteristics are as follows:

- **Loan purpose:** loans must be used to support small businesses in production, trade and the service sector. Consumer loans are not extended.
- **Loan size and repayment period:** every first-time client of USTOI is entitled to apply for a loan of BGL 600 or BGL 900 for a 4-month period, depending upon their anticipated capacity to repay. Good clients can submit successive renewal applications with the maximum loan size increasing in cycles with each additional application. The increase can be no more than 60 % of the previous credit for the second cycle and 30 % from third cycle onward up to the fifth cycle. The exact rate of loan increase depends individually on the specific needs of the business and the borrower's capacity to repay larger loans.
- **Interest rate:** loans accrue a flat monthly interest of 2 %.
- **Guarantees:** no material guarantees or collateral is required under the USTOI program. Loans are secured through a group guarantee. If a member fails to provide his or her installment upon the agreed day for payment, all other members are held responsible to settle the payment.

3. Problems Faced by the Program

The program faces the following problems:

- **Donor Dependence.** At the present time, the program is about two years old and will require donor support for at least another year. Operational sustainability is not projected until sometime in 2003, meaning that outside funds are required to maintain the operation until that time.
- **Single product focus.** USTOI presently offers one loan product, a group based loan of up to BGL 3000. As clients progress through the five loan cycles, they may well require more funds than are available through the present products. The best MFI or NBFIs may "cherry pick" their most profitable customers or the borrowers themselves will seek out other programs or financial institutions, leaving USTOI with the weakest clients.
- **Need to expand the client base**. This reflects the fact that the program is relatively new and is in a growing phase. Overhead (head office expenses) is approximately equal to or greater than the branch office expense. A branch is opening in Sofia and should be making the first loans in April. The larger client base in Sofia should help program growth.

4. Performance of the Program

The chart below provides a summary of the performance through the end of 2001:

Characteristics Of a Loan as of 12-31-01	**USTOI**
Largest Loan in $	$1,350
Smallest Loan in $	$275
Average Amount of Loan in $	$502
Longest Loan Maturity, Mo.	8 mo.
Shortest Loan Maturity, Mo.	4 mo.
Average Loan Maturity, Mo.	6 mo.
Highest Interest Rate by %	2%/mo.
Lowest Interest Rate by %	2%/mo.
Average Interest Rate by %	2%/mo.
Number of Different Types of Loans in Portfolio	1
Portfolio in Risk (>30days) ---% by Loans ---% by $ Value	 0 0
Number of Loans Outstanding	1598
Total Funds Outstanding	$592,729
Number of Clients	1659
Operational Sustainability	57%
Financial Sustainability	39%

B. Nachala (Supported by Opportunity International)

1. Description of the Program

The Nachala Foundation was established in 1993 with support from Opportunity International (OI), a global coalition of MFIs. The purpose of Nachala Foundation was to provide small business training and to manage a micro and small business-lending program for the Bulgarian American Enterprise Fund (BAEF). The Foundation received fees for originating loans for the BAEF. These loans were made from late 1993 until the middle of 1996 when lending was suspended due to the Bulgarian financial and economic banking crisis. The BAEF portfolio has been liquidated, except for a number of loans still in the collection process, some of which would have been written off the books, except for the requirements of Bulgarian accounting standards.

The 1996 banking crisis resulted in a suspension of lending for an eighteen-month period. This, coupled with changes in Bulgarian banking laws, severely restricting foundations and other non-bank institutions from generating revenue from lending activities, resulted in Nachala being re-registered as a credit cooperative in the fall of 1997. Nachala Cooperative started by taking over the staff and offices of the Nachala Foundation and began lending in late 1997 with financial support from USAID channeled through OI.

2. Description of Operations

Governed by a board of local and expatriate business and microfinance experts, Nachala Co-operative employs 38 people. In 2001 it disbursed 1,446 individual loans with a value of $2.8 million (average loan size just under $2,000) through a network of seven branches and its home office in Sofia. As of December 31, 2001, Nachala was nearly profitable, with a portfolio at risk (over 30 days in arrears) of 3.8 percent.

Today, Nachala has 21 loan officers each with an average of 68 clients. Nachala wants to open four new branches in the next three years (Vidin, Ruse, Burgas, Blagoevgrad). These regions have been selected due to their relative isolation from more populated parts of the country, and with higher incidence of unemployment and poverty. Nachala has determined that significant market opportunities exist in each city and the surrounding population centers.

Nachala makes individual loans in the range of $500 to $1,500 for first time borrowers. Second-cycle loans range from $1,500 to $2,500. Third-cycle loans and beyond are normally in the range of $2,500 to $3,500. The maximum loan size for third-cycle borrowers is $8,000, in most circumstances. However, in special cases Nachala will approve a loan for up to $20,000. The average size of current loans as of December 31, 2001 was $1,990.

All of Nachala's loan interest rates have been indexed to the US dollar to compensate for the volatility of the local currency. This volatility has declined substantially since the Bulgarian lev was pegged to the Deutsche mark. Interest on first-cycle loans is 17% on a declining balance. For second-cycle or beyond, interest on loans under $3,000 is 15% and for loans equal to or over $3,000, the interest rate is 16%. Interest on loans of second-cycle or beyond is also calculated on a declining balance basis. Repayment periods are based on the capacity of each client, determined through a business analysis at the time the loan is negotiated. The average repayment term of all Nachala clients is 11 months. Repayments for all loans are made monthly. Nachala supports a variety of business enterprises. A sector breakdown of the active portfolio as of December 31, 2001 is as follows: Trade 54%, Manufacturing 20%, Services 15%, Tourism 5%, Transport 3%, and Agriculture, Health Care, and other enterprises, 1% each.

The Danube River Initiative (DRI) program period has been extended to the end of March 2002, with the amount of $830,000 now drawn down by Nachala. During the period of this initiative, Opportunity has worked with Nachala to negotiate debt finance totaling $800,000. Sources include: $300,000 from the Bulgarian American Enterprise Fund, $300,000 from Oikocredit of Holland and $200,000 from a private US source.

3. Problems Faced by the Program

The program faces the following problem:

- **Continued access to loan capital.** The program experiences tremendous demand and must delay new loan disbursements until sufficient reflows from repayments are available. Due to the present legal and regulatory environment, Nachala has been dependent on donor funding. Unless legal changes enabling them to seek debt funding or take deposits, this dependence will continue.

4. Performance of the Program

The chart below provides a summary of the performance through the end of 2001:

Characteristics Of a Loan as of 12-31-01	**Nachala**
Largest Loan in $	$20,000
Smallest Loan in $	$300
Average $ Amount of Loans	$1,925
Longest Loan Maturity, Mo.	24 mo.
Shortest Loan Maturity, Mo.	3 mo.
Average Loan Maturity, Mo.	10.6 mo.
Highest Interest Rate by %	17%
Lowest Interest Rate by %	14%
Average Interest Rate by %	16%
Number of Different Types of Loans in Portfolio	6
Portfolio in Risk (>30days) ---% by Loans ---% by $ Value	 3.80% 3.86%
Number of Loans Outstanding	1,365
Total Funds Outstanding	$1,440,522
Number of Clients	1,365
Operational Sustainability	94%
Financial Sustainability	95%

C. Kasas (Supported by World Council of Credit Unions)

1. Description of the Program

The Employee Mutual Kasas is a structure that has been operating since approximately 1950. These mutual kasas existed in most companies and industries during the communist era and served as a means for employees to take small and relatively inexpensive loans. The only law acknowledging their existence is a reference to a 1989 trade union regulation. Most of these kasas are registered in the courts and have a bank account, but they do not pay any taxes on their income, though they do withhold taxes from the salaries of any full-time employees and pay employee social fund costs. Most of these kasas have only volunteer staff. Some have part-time staffs that receive very modest compensation.

The Cooperative Mutual Kasas (or Popular Kasas) developed as a result of some changes in the cooperative legislation in 1997. Before 1997, the Cooperative Act allowed cooperatives to engage in savings and loan activities. Many Popular Kasas and Popular Banks operated under this law from about 1994 until 1997. Many tried to revive the model of the Austrian Raiffeissen credit cooperative movement that was quite successful from the 19th century up to the end of the pre-communist era. However, due to the financial crisis of 1996, the subsequent legislation prevented cooperatives from having savings and loan activities. At that time, most popular kasas and banks closed either due to the financial crisis or to lack of legislation. Some, however, decided to form a mutual kasas within their cooperative to continue to provide financial services to their members. According to the Cooperative Act, the cooperative could form a mutual kasas. The members were responsible to adopt the rules of the mutual kasas. In most cases, the members adopted the rules allowing members to make share contributions to the cooperative on which they would be paid a market-rate of interest on their share balance. Therefore, these mutual kasas have an interest bearing savings product. They also provide loans to members based upon competitive market rates. Most of the Cooperative Mutual Kasas have a community charter and are limited to only serving members. The cooperatives are legally registered in the courts and are required to pay taxes on their net income.

World Council of Credit Unions, Inc. (WOCCU), which manages long-term technical assistance programs to develop, strengthen and modernize credit unions and credit union systems around the world, is providing technical support to 13 of the Cooperative Mutual Kasas and has plans to assist a larger number.

2. Description of Operations

These mutual kasas operate by requiring each member to make a monthly share contribution directly from their salary. This payroll contribution is usually between 5 to 30 leva monthly. No interest is paid on this contribution. The member is entitled to a loan (from 300 to a maximum of 2000 leva) if they have accumulated the required share to loan balance (between 1:3 to 1:5). Interest is charged on the loan up front (the nominal rate varies from about 2% to 10% annually). The loan is then paid on a monthly basis directly from the payroll. Loan terms range from 10 to a maximum of 24 months, and members usually are only able to obtain one loan per year. The main benefit of membership is to have access to an inexpensive loan. The main challenge for these kasas is fulfilling loan demand, since they are borrower-dominated institutions with no attractive products for savers. Most of the loans are used for personal rather than business purposes.

3. Problems Faced by the Program

Kasas have a dim future due to structural weakness of the organization, corporate mission, and products offered:

- Employee Kasas are disappearing as state owned firms are closed and liquidated;
- Mutual Kasas are oriented to borrowers and provide little or no remuneration to the capital that has been invested in the organizations;
- Limited benefits from kasas do not encourage employees of new Bulgarian companies to organize them;
- The boards of the Employee Kasas require further training in financial management and governance; and
- Current restrictive laws limit the products and services kasas can provide and unless this situation changes, expansion is unlikely.

4. Performance of the Program

The chart below provides a summary of the performance through the end of 2001:

Characteristics Of a Loan as of 12-31-01	**Kasas** (13 are WOCCU-Supported)
Largest Loan in $	$23,000
Smallest Loan in $	$28
Average $ Amount of Loan	$555
Longest Loan Maturity, Mo.	36 mo.
Shortest Loan Maturity, Mo.	2 mo.
Average Loan Maturity, Mo.	12 mo.
Highest Interest Rate by %	45%
Lowest Interest Rate by %	6.15%
Average Interest Rate by %	29.18%
Number of Different Loan Types	8
Portfolio in Risk (>30days) ---% by $ Value	8.05%
Number of Loans Outstanding	3,999
Number of Clients	11,067
Operational Sustainability	230%
Financial Sustainability	118%

The operational and financial sustainability ratios show high percentages but overstate the kasas long term sustainability due to the fact that kasas are only effectively lending capital of members on which they pay no interest. However, their limited funding and product offering drive members to other institutions for more serious business or large consumer financing.

D. Comparison of the three NGO's

The table below provides comparative information on the three NGOs.

Table 1: Loan/Portfolio Characteristics of USAID Supported Microfinance Organizations in Bulgaria

Loan/Portfolio Characteristics	Catholic Relief Services (CRS)	Nachala	WOCCU/ Bulgaria
No. of Clients/Borrowers (active) as of 12-31-01	1,659	1,365	1,067 clients 3,999 borrowers
No. of Clients/Borrowers (active) as of 12-31-02 (Estimated)	3,276	2,150	15,000 clients 6,000 borrowers
No. of Clients/Borrowers (active) as of 12-31-05 (Estimated)	5,678	4,500	30,000 clients 12,000 borrower
Percentage of Loans to Women	52 %	44 %	46 %
No. of Jobs Created by This Program During Year 2001	962 (962 new clients in 2001)	2,170	300
Primary Types of Loans in Use (Operating, production, equipment, building improvement, real estate, land, etc.)	Short-term operating	Operating, production, equipment, building	Microenterprise: 34% Housing: 10% Consumer: 55% Agriculture: 1%
Primary Use of Loan Funds (Working capital, material, production, equipment, vehicles, etc.)	Working capital	Working capital, material, equipment, vehicles	Working capital:30% Equipment: 4% Housing: 10% Household: 26% Vehicle: 20% Education: 9% Agriculture: 1%
Amount of Loan Portfolio (outstanding) in $ as of 12-31-01	592,729	1,764,504	1,491,747
Average Size of Initial Loan in $ as of 12-31-01	311	1,987	555
Loan Capital from USAID as of 12-31-01	438,285 ($2,000,000)	830,000 (All drawn down)	0
Outside Loan Capital from non-USAID Sources as of 12-31-01	154,444 (CRS private)	800,000 (Op.Int. /USAID)	0
Portfolio Growth by 12-31-02 in % (Estimated) (One Year)	71%	47%	42%

II. Review of Representative Non-Bank Financial Institutions

Other microfinance programs are beginning to emerge in Bulgaria. Four of them are briefly described below.

A. ProCredit Bank

ProCredit Bank is the first microfinance bank in Bulgaria with a corporate mission to offer credit to Bulgarian micro-, small- and medium-scale entrepreneurs as well as a full package of financial services to give these businesses the means and economic opportunity to expand and develop. The bank was founded in June 2001 by IFC, EBRD, DEG, Commerzbank and IMI. It began operations in October of last year under a full banking license.

The branch network is growing to cover the major regions in Bulgaria. There are currently seven branches: Sofia, Plovdiv, Varna, Burgas, Pleven, Stara Zagora and Haskovo. Six more branches are to be opened in 2002.

ProCredit Dynamo loans are being offered in the amount of $50 up to $5,000. ProCredit Business and Investment loans are being offered in the amount up to $125,000 for small and medium size companies for working capital and investment purposes.

The term of loan is 2 to 12 months on ProCredit Dynamo and up to 3 years on ProCredit Business and Investment. Interest rates are 1.65% monthly on ProCredit Dynamo and 14% to 16% annually on ProCredit Business and Investment. Collateral in the form of urban real estate and liquid assets and personal guarantees are taken in security of a loan.

B. Resource Center Foundation

The Resource Center Foundation established by the Soros Open Society Foundation launched the Micro Credit Program in 1999. The Program targets Bulgarian regions with high unemployment levels and low economic growth in order to facilitate Bulgaria's economic development and to create a climate conducive to the prosperity of SMEs.

The main activities of the Micro Credit Program are:

- Lending with priority to SMEs;
- Assistance in providing alternative sources of funding for emerging SMEs in need;
- Providing resource support for small business in the form of free consultancy;
- Providing technical assistance in the field.

The Micro Credit Program partners are:

- Soros Economic Development Fund (SEDF), New York, acting as guarantor of the lending program;
- UBB, Sofia, acting as the originating lender; and

- The Resource Center Foundation, which has established seven offices throughout Bulgaria during the last two and one-half years for receiving loan applications. The portfolio of each office is called a Microfund.

This Micro Credit Program operates as follows:

- The SEDF opens a standby letter of credit in favor of the UBB as collateral for potential credits amounting to $500, 000 for each Microfund;
- UBB reviews loan applications initially received by the Microfund and makes an independent credit decision on whether to fund each loan.
- The Resource Center Foundation streamlines the commercial bank's lending process by providing the institutional interface with loan customers—accepting loan applications, initially analyzing credits to screen out those not meeting the basic credit standards, marketing to and consulting with potential clients, and managing the loan relationship.

Microfund loan terms and conditions are as follows:

- For business start-ups:
  Up to $2,000 (first-time loan)
  Up to $4,000 (subsequent loans).
- For existing SMEs:
  Up to $5,000 (first time loan)
  Up to $10,000 (subsequent loans)

Increases in subsequent loan amounts depend on the capacity of the business to repay the increased loan amount. Loan maturity is up to 12 months for working capital loans and from 24 to 36 months for plant, equipment and business investment loans.

Since 1999, the Resource Center and the UBB have made 402 loans for a total of $2.6 million. These loans have generated 823 jobs, including 35 part-time jobs throughout Bulgaria.

C. Job Opportunities through Business Support Project (JOBS)/UNDP

The Job Opportunities through Business Support Project (JOBS) is implemented by the Ministry of Labour and Social Policy with the support of the United Nations Development Program (UNDP). The project has a total budget of $7 million, of which $6.7 was provided the Bulgarian government. UNDP and the Belgian and Spanish governments supplied the balance of the funds.

The project objective is to generate employment and promote entrepreneurship by supporting micro, SMEs and agricultural producers. Beginning in November 2000, JOBS is being implemented over a two-year period. To date, JOBS has created a network of 24 Business Centers, including eleven Business Incubators and three Business Information Centers. All are now functional, though some are still in temporary quarters, and provide a wide range of business services.

At each Business Center or Business Incubator, a flexible microfinance mechanism has been established, in the form of "lease purchase" or a financial lease. Almost $2 million is available to micro and small companies to enable them to lease equipment purchased by the funds. To date, over $300,000 has been advanced for 38 financial equipment leases. Furthermore, lease applications valued at $400,000 are in the pipeline. The lease rate is the BNB base rate plus 10% or currently about 15% per annum. The lessee must put 20% of the equipment purchase price down and purchase the equipment (up to $10,000) at the end of the 24-month lease. Therefore, the Business Center is not expected to have equipment returned.

All Business Centers and Business Incubators have Information Technology Centers. Each Information Technology Center offers local businesses access to the Internet and current market information.

D. Bulgarian American Credit Bank

The Bulgarian American Credit Bank (BACB) is a wholly owned subsidiary of the Bulgarian American Enterprise Fund. It provides a variety of commercial and mortgage loan products primarily in the major urban centers of Bulgaria. The total loan portfolio is approximately $53 million and growing.

BACB has been one of the more innovative commercial banks in Bulgaria and the fund's chairman was named “Banker of the Year” in 2001 by the Bulgarian Bankers Association. BACB successfully issued the first mortgage-backed bonds in Bulgaria beginning in August 2001 and is rapidly expanding its mortgage lending. A growing number of small business entrepreneurs are using this product to obtain working capital for their firms without having to enter into onerous covenants typically associated with commercial business loans. BACB is lending from 60 to 70 % of the fair market value of urban real estate. Loan size ranges from a few thousand (primarily mortgage loans in the $10,000 to $25,000 range) for SME lending to a maximum of $4 million for large commercial projects. The bank is rapidly developing new products to aid Bulgarian businesses with trade finance, inventory loans and other commercial applications. Currently, BACB has the highest operating costs of any Bulgaria commercial banks, but it has placed a high priority on finding methods to reduce its interest cost to borrowers.

IV. Specific Issues related to Microfinance

A. Major Constraints to Credit:

In Bulgaria, the commercial banking sector has been slow to develop SME lending. Access to credit for the poor, individuals, consumers and entry-level entrepreneurs, particularly in rural areas, is not available except through the programs supported by USAID and other donors. One example is the EU PHARE program supporting the establishment of 33 credit cooperatives that are providing these services in rural areas of Bulgaria. Commercial banks continue to view this type of lending as unprofitable, high-risk, and labor intensive. Some banks have started small micro and SME lending programs. Most banks, however, will not enter this field for sometime and are only likely to do so when they observe banks and NBFIs successfully demonstrating that the risk of this type of lending can be successfully, efficiently, and profitably managed with the proper policies, procedures, and trained staff

For potential borrowers, requirements by even the NBFIs to qualify for loans can be daunting. Most NBFI lenders are requiring 200% and more collateral coverage for the loan amount. For most prospective borrowers, the only security they may have is their apartments and sometimes their automobiles. Borrowers are typically required to obtain guarantors in addition to the pledged security. In the CRS group loan program, every member of the group is liable for the repayment of the loan if the borrower defaults. These very stiff collateral requirements present a formidable constraint for access to credit by a poor borrower. In rural areas, where the real estate market has not been fully established, many borrowers still have no means to provide the necessary collateral required for even microfinance loans.

A second constraint for borrowers, particularly new entrepreneurs, is the short loan repayment period. Most loans in Bulgaria, whether from commercial bank or NBFI, are for less than one year. For equipment and facility loans, repayment in less than one year requires very high down payments or very large monthly or quarterly payment. These are very difficult loan terms for any business to service. This often leaves little or no income for the borrower to us to pay living expenses or overcome business start-up problems that are common to all new businesses.

For NBFI lenders, the lack of legal status and of a regulatory and supervisory framework has limited their access to capital to donor funds and membership fees from the members seeking access to credit. This severely limits the availability of funds to meet the demand for micro and SME lending.

All lenders—NBFIs and commercial banks alike—also have problems that restrict their ability to lend more money more easily. Foreclosure on collateral in a timely manner after a loan default is frequently cited as a major credit constraint by lenders. The lengthy court action necessary for collateral foreclosure, corruption, and frequent regulatory and legal changes, are additional problems. As these issues affect all lenders and will require a broad-based solution that will require the cooperation of the banks, NBFIs, and the GOB to resolve. This report will not dwell on these issues but focus comments on those constraints and issues that more exclusively impact NBFIs and their customers.

Table 2 in Annex A provides a summary of credit constraints reported by borrowers and financial institutions interviewed during this assessment.

B. Credit Demand and Supply

The demand for access to micro and SME credit is quite strong in Bulgaria. NBFIs and commercial banks interviewed during fieldwork, reported strong demand for this type of lending. More than 75% of the lending institutions reporting estimated a need for an increase of at least 50% in the availability of funds to meet the demand in this category of lending. Approximately 25% of the respondents indicated that the demand exceeded 100% above the amount currently available for lending.

Tables 3 and 4 in Annex A provide a detailed summary of the credit demand responses from NBFIs and commercial banks.

The review also indicated a strong need for longer-term (more than one-to-two years) credit for small businesses. This type of credit is generally not available in Bulgaria from any lender for any customer. The BACD has had mortgage-based products available for several years, but it is only with the recent issuance of mortgage backed securities that slightly longer term lending is starting to be more widely available. Even in this example, lending is limited to large urban areas where the real estate market has become well established.

The Team observed a gap in lending availability to entrepreneurs in loan sizes between $5,000 and $20,000. Reports from successful new businesses seeking to graduate from SME to commercial bank borrowing indicated a real need for credit in this range. Many reported that after successful start of their businesses, they were faced with a situation in which they were basically required to start all over to establish creditworthiness in order to begin borrowing from commercial banks. Preparation for graduation from the micro and SME lender to the commercial bank does not exist and should be a part of any NBFI lender program.

To have adequate funds to meet demand, NBFIs will be required to obtain access to debt financing, including deposit taking, before they will be able to respond to demand and reach long-term sustainability.

Commercial banks will continue to move toward SME lending as they observe successes in the NBFI programs and offer competition for microfinance programs to become sustainable. However, this process may take a number of years. The operating results of the newly formed ProCredit Bank (June 2001) are being closely watched in Bulgaria. If successful, it may encourage commercial banks to move more actively into the SME lending sector. Many believe, however, that rapid development and disbursement of $600,000 in small loans in less than six months will result in poor loan portfolio performance.

C. Feasibility of New Products and Future Undertakings

Demand for new products is primarily focused on the need for longer-term loans to support equipment and facility development and leasing products. USAID has facilitated a pilot microleasing program under the UNDP-supported leasing project in Vidin. The final evaluation of that program in October 2001 was very positive. UNDP has expanded the pilot to 24 business centers throughout Bulgaria. The program is still small, with $300,000 in lease financing in place and an additional $400,000 under review.

Borrowers interviewed identified strong needs for loans for agricultural production, facility improvement, leasehold improvement, and real estate purchase. Table 5 in Annex A provides a summary of the responses for new product demand in NBFI lending.

Further development of the real estate market in Bulgaria outside the major urban areas, as a source of collateral, and development of equipment and facility-based loans, will be needed before lenders will have sufficient collateral to meet longer-term loan demand. Lease products represent an alternative solution for providing access to needed equipment for business development for those businesses able to meet down payment and lease terms. For the lending institutions, access to longer-term funds, such as mortgage-backed bonds (BACB issued the first mortgage backed securities in late 2001) will also be needed to make longer-term loans safely.

The need for longer-term fund sources is another issue common to NBFIs and commercial banks. Development of longer-term fund sources is likely to be more quickly resolved by commercial banks in Bulgaria than by NBFIs until the latter's legal status is resolved. Access to additional capital for lending will be needed to meet even shorter-term product needs, such as production lending.

D. Strengths, Weaknesses, Opportunities and Threats to USAID Funded Credit Organizations.

Each of the three programs reviewed has demonstrated substantial progress in the development of their programs during the past two years. As part of the review process, Nachala, CRS, and WOCCU were asked to respond to a series of questions concerning strengths and weaknesses, governance, internal controls, products and market position. They also addressed opportunities and threats they perceived, including questions regarding sustainability. A summary of their responses is provided in Table 6 and 7 in Annex A.

The greatest area of concern remains the ability to raise capital to meet lending demand and achieve sustainability through efficient administration of a loan portfolio large enough to support the banking staff necessary to manage it. None of the programs can sustain needed capital development without resolution of the legal, regulatory and supervisory framework.

Theoretically, the "kasas" are existing NBFIs that could continue to operate without donor support. There are approximately 500 "kasas" still operating in Bulgaria, only 13 of which are receiving program support from WOCCU. While these kasas could continue their very limited operations, they have demonstrated little ability to increase in size to meet the growing needs of their members. As currently structured, this situation cannot change unless "kasas" are also provided some additional means of raising capital for lending. Based on their history, it is likely that many "kasas" would elect not to use any new authorities to raise capital even if such authority were granted. In the long term, these "kasas" will continue to operate so long as their affiliated employer continues to exist and individuals are willing to work for little or no money to manage their relatively simple business. However, it is doubtful that such institutions will be able to expand at all if they are not responsive to member needs for credit.

Governance and internal controls require additional training and development of qualified managers and board members to assure that the objectives of the institutions are met. The guidance provided by the technical assistance providers has been an important factor in meeting these objectives for the participating "kasas".

From the perspective of public safety and soundness, regulatory and supervisory oversight would be important if the "kasas" were to expand beyond their simple business of providing very limited lending to their members who are also employees of the affiliated employer. Larger and more robust "kasas" that offer products and services similar to modern day credit unions worldwide would need stronger corporate governance, skilled management, and internal control procedures to provide reasonable assurance that they would operate in a safe and sound manner, leading to sustainability. Critical to the future of the "kasas" is for their boards and management to declare what their long-term institutional goals are. Donor assistance can only be effective with institutions that have fundamental goals indicating what they want to achieve during the next five years. If they choose growth and expansion as primary goals, then additional loan products will be needed to support entrepreneur-borrowing needs in the future.

For the near term, Nachala, CRS and WOCCU each serve niche markets and are not competitors among themselves. With the exception of ProCredit Bank, EuroBank, UBB, Postbank[3] and Encouragement Bank[4], they have little competition. Over time, this will change as SME lending continues to develop.

E. Prospects for Sustainability of Microfinance Organizations

Of the three organizations reviewed, only WOCCU reported having reached full operational and financial sustainability. However, "Kasas" working with WOCCU were already established and operational institutions at the time that the program was undertaken. Presumably, they would be able to continue their operations as before should the donor program terminate. Therefore, their "sustainability" has not really changed. The WOCCU program was designed to broaden and strengthen the "kasas" management and operations to serve their members with broaden products and services. However, the "kasas" have demonstrated a lack of ability to grow their organizations at a rate that can sustain their members' expanding borrowing needs. The "kasas" lending activity, as is traditional for this type of organization, is more active in consumer lending than the other two programs reviewed.

Nachala expects to reach financial and operational sustainability during 2002. CRS expects to achieve only operational sustainability by 2003. Table 8 in Annex A summarizes the plans and evaluations by the program directors of their current and future sustainability.

For all three organizations, donor funding and assistance will continue to be needed to provide adequate capital to meet growing lending demand in the near term. Nachala has been successful in obtaining some debt financing in addition to donor resources. CRS continues to depend on donor funds for all increased lending activity. Both of these entities require donor-supplied funds to expand. Without these donor funds, these programs cannot expect to continue very long. Public sources of commercial debt capital are not likely to provide large loans to these programs until they have demonstrated sustainability or near sustainability. They are also likely to be granted the authority to take deposits. WOCCU expressed the view that internally generated funds in their "kasas" would meet borrower needs. However, it is doubtful that even the "kasas" can fully respond to member needs in a timely manner solely by this means.

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[3] UBB, Eurobank and Post Bank are the three banks selected by the Ministry of Labor and Social Policy to intermediate approximately $10 million in government funds to micro and SME borrowers in the $5,000 to $15,000 range.

[4] Encouragement Bank is intermediating $10 million from EBRD and $10 million from the European Investment Bank to SME borrowers.

Once reaching the break-even point, all three programs will need long-term funding sources to intermediate into loan products and services. Thus, the long-term sustainability depends on the ability of the institutions to obtain traditional sources of capital to meet future member borrowing needs and to grow large enough to be able to sustain efficient operational costs.

F. Competitiveness and Diversification of Credit Products and Providers

Nachala, CRS and WOCCU projects have very limited competition in microfinance lending. The projects themselves serve very different niche markets. Nachala has the most traditional microfinance and SME lending and has been an effective lender for new entrepreneurs seeking business loans. Of the three programs reviewed, this program has provided the most significant economic impact for Bulgaria and has the most efficient operations. CRS is built on group lending that is a particularly specialized niche market for borrowers who are least able to obtain credit from any other source. Over time, borrowers should be able to qualify for individual MFI and SME loans.

WOCCU's program is targeted at expanding the lending activities of Bulgaria's credit unions known as "kasas". These institutions have relied on member fees to generate funds for very small loans that have typically focused primarily on consumer lending. "Kasas" membership assures individuals the opportunity to have access to credit they might not otherwise be able to obtain. There are no dividends or other apparent financial benefits to members from their ongoing payments to the "kasas."

Other donor-supported programs exist in Bulgaria, such as the 33 agricultural cooperative lending institutions. These programs as a whole as still relatively small and do not tend to compete with each other. The new ProCredit Bank has actively solicited some potential CRS customers. They also compete for customers similar to those served by the Nachala program. ProCredit Bank is modeled upon similar successful banks that have received technical assistance from the German firm IPC and the German Commerzbank. One of these institutions, Market Bank in Sarajevo, was developed under similar circumstances and has subsequently been purchased by a major Austrian Bank. Other such micro-enterprise banks have been established in Kosovo, the Republic of Georgia, and Croatia, and are conducting a very profitable business serving micro and SME customers. Commercial banks are beginning to develop small SME programs. The BACB is also developing an effective SME lending program and is aggressively working on new mortgage-type products to meet SME borrower needs.

Microfinance programs tend to have higher interest rates. In the early stages of their development, they require financial support for their administrative operations as well as capital from donor institutions to have adequate funds to meet loan demand. Initially, the products offered are very limited. Nachala has the most diversified types and loan limits and will be better suited to compete with emerging banks that appear to be interested in testing the micro and SME market. More product and services diversification will be needed if these programs are not to become marginalized. An interesting product for the micro and SME customer market is the leasing program developed under the JOBS Project supported by UNDP, which provides a two-year term for leases of equipment or facilities.

Over time the growth of competition will encourage NBFIs to increase the number of people served and will result in more product diversification, better suited to meet specific business and borrower needs. Commercial banks have historically been slow to move into this market and will do so only after NBFIs have demonstrated that it can be done with reasonable risk and can be profitable.

G. Target Groups of Borrowers and Regional Outreach

Microfinance and SME programs have yet to reach all the areas of Bulgaria where there are potential customers that may benefit from this type of lending. Microfinance and SME loan programs, including the three USAID supported programs, are primarily focused in urban areas. Much of the country is still open for customer development should the funds be available develop additional markets. Table 9 in Annex A indicates that program customer respondents stated that demand was strong for additional lending capacity across all categories of target groups and by region of the country.

The reviewed programs have made significant progress in making loans available to women but have only been able to provide service in very limited geographic areas. As loans are expanded to other areas, their intention is to continue their efforts in to provide financial services to women and women-owned businesses.

H. Risk Management, Loan Size and Interest Rate Structure

The Team used the percentage of portfolio at risk over 30 days as a measure standard. Using this basic standard, the CRS/Ustoi program has the best performance with no delinquency. Nachala, with 3.9% of its portfolio at risk, has the next best record of performance. The WOCCU credit union "kasas" had 8.05% of their portfolio at risk. That is high but is down from a 15% rate of two years ago.

Loan size in the programs varies widely with the smallest loan being \$28 and the largest \$23,000. The average size of loans ranges from \$500 to approximately \$2,000, which is more representative of microfinance lending worldwide.

Nachala's interest rate is averaging 16%. This is comparable to other SME programs in Bulgaria from all sources. CRS/Ustoi's flat interest rate of 2% per month is close to 41% on an effective annualized rate basis. "Kasas" charge a 6% rate, which is deducted in advance from the loan proceeds. The annualized effective rate for these loans is approximately 11%. Since kasas member deposits receive no dividends or interest on shares, this reflects an effective spread of 11% on loans to members. Considering the strong collateral requirements and the requirement for loan guarantees, these are aggressive rates for borrowers least able to obtain other sources of credit. These rates will need to be reviewed and will certainly begin to feel competitive pressure as additional sources of SME lending emerge. Microfinance lenders may want to consider the suitability of incorporating cash flow and character based lending and to re-evaluate requirements for the use of excessive collateral and loan guarantees.

I. Comparison With Experience in Other Transitional Economies

The Team was asked to focus considerable attention on the issue of a legal and regulatory framework for MFIs and NBFIs. The BNB, fully occupied with regulatory and supervising commercial banks, maintains that these institutions do not pose any systemic risk to Bulgaria's financial system and therefore need not be regulated.[5] This is an understandable position given their current resources and responsibilities. Some NGOs and microfinance programs argue that MFIs should not be regulated at all as the lending funds come from the NGOs or the members themselves, and they do not need the government to tell them how to run their self-contained businesses.

A more thoughtful response looks at the seminal issues of prudential regulation of financial institutions —what is to be regulated, what interests are being protected, and who should do it. A look at the experience of neighboring Eastern European countries can be helpful.

A first issue is whether MFIs should be regulated at all. There are many who argue that credit-only MFIs, which lend member capital or member deposits to members, do not pose any systemic risk to the public. The members themselves, through their cooperative vote or other corporate representative, have the ability to exercise some control over the institution. A closer look uncovers the truth of experience. Member-owned organizations—whether cooperatives, credit unions, equal partnerships or the like—generally give each member the same voting power over the organization. What this does in effect is give the incumbent or inside group strong power to control the organization. Any opposing individual or group of individual must muster enough votes for their ouster. The global landscape is littered with failed financial cooperatives where the insider group lost, embezzled, or otherwise converted the funds to their own use. That there are dangers to non-regulation should be clear, but is it worth government intervention?

Those NGOs and institutions which favor regulation often believe that this will promote more MFIs, more funding, and will encourage changes in legislation that will provide them the ability to take deposits and secure a funding base. Furthermore, they can then advertise that the institution is safer because it is regulated, encouraging more borrowing.

Based on experience elsewhere, none of these is a sound rationale for regulation. MFIs generally receive funding from NGOs, donors and some international financial institutions. While these institutions want them to be well run, often, they are not. Whether an institution should be allowed to take deposits should depend upon their demonstrated ability to manage those deposits safely, not on the quality of their donors or benefactors. Whether the institution can manage their prudent use or safe return to customers on demand is the overarching concern for granting such authority. Deposit taking authority should not be automatic merely with the implementation of a regulatory regime over the institutions. The institutions must also demonstrate that they deserve to be allowed to exercise what the statute permits the regulator to grant.

[5] The BNB is quick to add that these institutions should not be allowed to take deposits.

Prudential regulation arises from a need to protect systemic risk of the financial sector from disintegration and collapse. Business and the public depend upon an effective and efficient financial sector to facilitate business transactions that support growth of the economy and the rising welfare of the public.

The public, the economy, and the business community all have expectations that the government is the appropriate body to establish the operating rules for business and financial activities—even business activities with consumers—and to enforce them. All financial institutions intermediate funds from creditors to debtors. The collapse of any financial institution or a group of financial institutions has an impact upon the debtors and creditors that they serve. Having stated this, choices must always be made on what level of prudential regulation is needed for what type of financial institution and at what cost to reasonably assure the public that any type of financial institution is operating safely and soundly. This does not guarantee that institutions will not fail but that they are allowed to fail within a system that as a whole continues operating.

A multi-tiered regulatory system that gradually increases regulation depending on the type of institution and the products and services it offers is appropriate for the type of NBFIs serving Bulgaria. The nature of the financial institution and whether it is credit-only, member only, limited to member deposits, or accepts deposits from the public, provides micro, small, or larger loans—all impact the level of prudential regulation that is appropriate.

In all cases, the central bank should have ultimate authority to intervene as it determines what is prudent for the safety and soundness of the institution or institutions being regulated as well as the public it serves. All financial institutions face financial crises at some point and all interested parties expect the government to take action. In fact, most types of financial institutions have a financial crisis about once every generation. In the case of Bulgaria, the BNB needs to have full authority to act during any crisis even though the authority may not be exercised for many years.

Costs must be faced squarely. Demanding that prudential regulation is necessary without providing adequate resources to implement the requirements is irresponsible. Lower levels of regulatory concern, however, can be addressed with lower levels of regulation and oversight while always maintaining the authority to intervene during those extraordinary times of financial crisis.

The BNB is quite correct in its position that it should not waste the time of its few highly trained supervisors on entities that pose little risk to the broader economy. Bulgaria and the BNB do not want to end up like the Philippines. The Philippines Central Bank must regulate more than 800 very small rural banks serving only one-half million clients with less than 2 percent of the nation's banking assets. Yet these 800 banks make up more than 80 percent of the institutions that the central bank is required to supervise.

Does this mean that small banks should go unregulated? Costs and levels of regulation can be developed which are appropriate for the type of institution. A nongovernmental regulator, operating in a framework in which the central bank has ultimate authority and control would appear to be the appropriate solution for the breadth and variety of small NBFIs serving small businesses and consumers.[6] This approach gives the central bank the authority to intervene in times of crisis, but not the cost or responsibility to examine or supervise in normal times.

Consideration of regional experience is very relevant. Europe has much more financial institutional experience than most areas that have experimented with MFIs over the last three decades. Western Europe has a myriad of NBFIs, some of which have operated for as much as 150 years. The financial cooperative or mutual associations spawned on the model developed by Dr. Raiffeissen have operated throughout Central and Eastern Europe for more than 100 years with a system of nongovernmental and government regulation developing over the last fifty. Memories of the benefits of these institutions in Bulgaria and other Eastern European have faded but are not forgotten. There are reasons to believe that this model is appropriate for Bulgaria.

In Bosnia and Herzegovina, the Local Initiatives Project (LIP) has supported business development, particularly among low-income entrepreneurs since 1996. Among the objectives was the charge to create an appropriate legal and regulatory framework for the provision of credit and services to low income entrepreneurs. As part of the project, a law covering microfinance organizations was developed by international and local legal advisors and was enacted. The World Bank Group has since approved a $20 million credit to finance a second LIP in Bosnia.

Croatia has begun a similar process, which is not yet complete. The World Bank initiated a LIP-type project, once again conditioned on the government adopting a microfinance law. In Croatia, however, legislation proceeded down two tracks. Draft legislation would authorize the formation and operation of nonprofit, nongovernmental organizations as "credit-only" MFIs. In this draft legislation, now before the Croatian Parliament, the Law on Associations would authorize Croatian NGOs to operate as "microcredit associations." In another legislative effort, groups are interested in amending the Law on Savings and Credit Associations to permit microfinance lending. Neither legislative effort has passed Parliament yet, though the World Bank is very interested to enable MFIs to operate as freely in Croatia as they are in Bosnia.

Banking laws should be tailored to the greater financial sector as a whole and the markets and customers they serves and not special interest groups. Carving out micro-finance institutions alone does not advance the broader financial sector development. Both Poland and Hungary have developed banking laws to serve a broader base of financial institutions, not just MFIs, though MFIs and a variety of NBFIs are permitted and operational in Poland. In the early days of Poland's transition, the major Polish MFIs were thriving. As the economy has become more robust, transforming the former "sick" man of Eastern Europe to one of the leaders for EU Accession, microfinance lending has plateaued and SME lending has strongly moved forward.
Hungary has also authorized a nongovernmental regulator, which has its roots in the land bank system in Germany.

None of these countries declines to regulate these institutions entirely. Better to have a broader NBFI regulatory framework tailored to all types of financial institutions based on the

[6] Some commentators decry use of nongovernmental regulators as not working anywhere. This proves too much as NGO regulators are rarely under the direction and authority of the Central Bank. The Central Bank must have ultimate authority during infrequent NBFI crisis and to mediate and resolve any conflicts of interest.

capitalization, products, services and customers they serve. This approach provides flexibility to the institutions and the customers so they can graduate and evolve as their businesses and situations evolve and grow. This approach allows both MFIs and all types of NBFIs to be covered. A comprehensive framework for such an approach is discussed in the next section.

J. Legal Status of Microfinance Organizations and Future Legal Framework

This review focused on NGO microfinance programs supported by USAID. However, the observations generally apply to the full range of non-bank micro and SME lending institutions currently operating in Bulgaria. The MFIs include two types of NGO-supported MFIs —mutual kasas or popular banks and credit cooperatives (as a group, non-bank MFIs).

While most of these institutions are operating legally, their legal status is temporary and uncertain. Some, such as the Private Mutual Rural Credit Associations (PMRC) (commonly known as the Agricultural Credit Cooperatives) have specific exemptions to operate under the Law on Banks. The PMRC exemption is limited to the 33 cooperative lending institutions authorized in the article of the law. The lack of a statutory and regulatory framework to ensure the legitimacy and long-term sustainability brings into question the ability of other NBFIs to provide needed services to their customers. Customers are always going to be tentative toward these institutions until their charters are perpetual.

Each of the reviewed groups indicated recognition of the need to develop a proper legal and regulatory framework for the non-bank MFIs as an important element for them to achieve sustainability. The rationale for a well-defined legal and regulatory framework was discussed with each of the reviewed institutions. This rationale included:

- Institutions that are regulated and supervised are better able to obtain debt, including deposits, and equity funding to expand their operations;
- Borrowers and savers gain greater confidence in regulated institutions;
- Even though NBFIs do not currently take deposits, their bankruptcies would have a significant impact on their customers, particularly those whose only access to credit is through borrowing from one of these institutions;
- Because these institutions serve the shadow economy that is often not adequately recorded in official data, the information that the NBFIs would report could give the BNB better information for economic forecasting;
- As a practical matter of experience, it would not matter whether or not the BNB has legal responsibility for NBFIs, the public would blame a failure of any of them upon the BNB, just as they blame the BNB for losses from pyramid funds.

The primary issues addressed by the organizations with regard to legal status and supervision and regulation follow:

1. **Description**

a. Legal Entities:

The Law on Banks recognizes only stock companies as legal entities eligible to obtain authorization for activities covered by the law. Mutual and cooperative institutions are not included in the law as eligible entities for the purpose of conducting banking activities. The PMRCs thirty-three cooperatives are given status only as a part of their exemption in the Law on Banks. Other MFIs obtained their exemptions through memoranda of understanding regarding their programs.

b. Capital:

Capital for the MFIs comes as a condition of entry as a member of the institution or has been provided by donors through the NGOs. As new members are added, they bring additional capital to support any financial services provided to the expanding member base. Unfortunately, the NGOs do not require (and their members probably could not pay) sufficient capital from new members to support the MFIs services to the new members. However to become sustainable organizations the institutions must develop a sufficient level of financial resources to provide support for the cost of administrative operations of the company for all members. None of the institutions appears to be able to achieve adequate financial resources from member fees alone to meet this objective in any reasonable length of time. To become a positive addition to the finance sector and to conduct commerce, the institutions must become sustainable in their operations.

None of the MFIs has authority to take deposits from the public. As non regulated and unsupervised institutions their ability to raise debt and equity funds for lending is also severely limited, although some of these institutions have been able to recently obtain some debt funding from commercial banks under very strict terms. Each would be lender would have to perform its own due diligence to assess whether the MFI is a good credit risk for placing some debt capital. This due diligence process is likely to drive up the costs of funds too high for the MFI to be able to service the debt. Most large debt lenders would rather than the institutions be regulated, not only to facilitate the due diligence process, but also to assure that someone else other than the lender is also looking at the safety, soundness and financial health of the institution. The World Bank, for example, for the most part, only approves financial institutions that are regulated and supervised as eligible to receive funds from a World Bank credit line. Thus the ability to grow the microfinance and SME organizations to a size that will permit sustainable operations is severely limited under their current status as non-regulated and supervised institutions.

Minimum capital to get a bank license is э5 million according to the bank act. This substantially exceeds the capabilities to raise capital through member contributions for most MFIs and NBFIs. The EU Banking Directive 2000/12 Article 5, section 2 allows an exception to the minimum capital requirement for cooperative credit institutions of э 1 million. Realistically, Bulgaria should consider the appropriateness of harmonizing its legislation for NBFIs as consistent with those of other EU countries. All of these types of institutions are licensed to operate through Banking Acts in various EU member countries. It is expected that additional exceptions may be considered to allow countries with institutions not meeting the capital requirements for accession to correct problems that may exist. Should legislation be enacted, consideration must be given to a capital structure that realistically recognizes the need for adjustments to the capital requirements for MFIs combined with a limitation on the types of bank services the institutions with reduced capital may provide. Both should be evaluated.

c. Membership:

The lack of regulation and supervision may also have some impact on the confidence of the public to invest membership fees in these organizations and thus slow or limit their rate of growth. The primary incentive for individuals to become members remains the ability to gain access to borrowed funds that are not otherwise available to the sectors of the economy not served by the commercial banking sector.

During the course of the review additional legal and regulatory issues were raised, the most significant of which are outlined below.

d. Capital Adequacy:

The capital adequacy requirements, including reserves for liquidity and loan losses, provisioning and risk assessment need further evaluation as they relate to MFI lending activities. The maintenance of "Highly Liquid Collateral" (such as government bonds, cash, insured or private immovables) as listed by BNB regulation cannot always be provided by micro and SMEs customers. NBFI would have to either forgo these customers or make additional reserve provision against any loan with insufficient collateral under these regulations. In general, the law makes no distinction concerning risk-assessment of companies in regard to their size. More tailoring of these types of regulations to the risk of NBFI customers would be appropriate.

e. Law on "Special Pledges":

The Law on "Special Pledges" refers only to legal entities. Enforcement procedures are considered by many to be inadequate and ineffective. More efficient foreclosure procedures on collateral upon default are needed. . For example, cars are frequently used as collateral for micro and SME loans. Auto leasing is one of the largest growing areas of financing in Bulgaria today. And yet, the law provides only limited protection to the lender for collateral of this type. Most jurisdictions allow lenders to take non-confrontational self-help measures to gain possession of the automobile pledged. These approaches may be appropriate for Bulgaria to consider.

The use of "Unregistered pledges" as an alternative is impractical. While taking a pledge and not registering it involves less administrative effort and would lower micro and SME loan administrative costs, "unregistered" pledges require the lender to take physical possession of the collateral or risk being last in priority if the borrower pledges the collateral again. Taking possession is not practical for the micro or SME borrower, who often need the use of the collateral. Not taking possession is considered too risky by the lender.

f. Court Procedures:

Court procedures for collateral enforcement are too cumbersome and time consuming. Cases can take up to two years to resolve. At the moment, the courts tend to favor borrowers. Cases are reported where judges ordered the surrender of a harvesting combine only after the harvest was completed. There are many loopholes for borrowers to avoid the lender's foreclosure and possession of the collateral. For example, debtors may contest the pledge value and demand sale of the pledged items for prices that cannot be achieved in the open market. A market based pledge law review appears appropriate to improve lender's ability to collect on collateral and thereby enabling them to require less collateral to support a loan. Lower collateral requirements can only increase borrowing opportunities for micro and SME borrowers.

g. Central Credit Register:

The central credit register does not accept loans in amounts of less than э 5,000. This prevents MFIs and NBFIs from making effective use of this tool to submit and retrieve information on outstanding loans of their customers or prospective customers. Surely, computerization and storage technology would enable a separate small loan registry database.

h. Corruption and permits:

Borrowers pointed out that the large number of national and local government and municipality permits and forms required for businesses to operate in one or more regions continues to be an impediment to them. Corruption and payment of monies to expedite permits while not large in absolute terms is expensive and time consuming for the micro or SME borrower. Expedited permit or form approval is simply more money. Unfortunately, the low paid government officials will resist any change to this petty corruption system as it supplements their salaries.

i. Tax Laws:

Tax laws are complex and discourage formation of new businesses. Revisions to the code to simplify or even provide tax incentives for small business were suggested as legal areas that needed further evaluation.

Most of these issues are not unique to the NBFIs and are being experienced by commercial banks and businesses of all kinds. . They appropriately need to be addressed on a broader scale for all financial institutions. While the team makes note of these legal and regulatory issues, it has not proposed recommendations unique to NBFIs but suggests that the institutions should work with the financial community and the GOB to seek resolution and removal of these obstacles to sound credit operations for all businesses and financial institutions.

2. Analysis:

The NGO supported NBFIs have provided valuable loan and other financial services to poor and average citizens that are not being served by commercial banks. NGO support has been valuable to these MFI's institutional growth both in increased loan volume and greater staff skills and expertise. Not unimportant has been the NGO support in minimizing their administrative costs. Careful lending using a number of proven methods for delivering micro finance such as group lending, peer pressure and sound collateral have led to a very low rate of non-performing loans. MFIs and NBFIs are providing credit to facilitate the establishment of small business enterprises and their continued successful operation. Typically, the existing MFIs are providing loans from less than a thousand dollars up to ten to fifteen thousand dollars. Commercial bank business lending in Bulgaria usually has a minimum of approximately twenty five thousand dollars. Thus, there is an apparent gap that currently exists between the credit offered by MFI and NBFI lenders and the market served by commercial banks.[7] This has created a problem for entrepreneurs as they grow their businesses and require additional borrowing resources and business services. In some instances, small business owners have been faced with almost starting over in their banking relationships as they try to transition from MFI loans to traditional lending and commercial banking services.

Typically, commercial banks are slower to develop programs for SME loans, which are considered expensive to administer and higher risk. Traditional MFI lenders have not been competitors of commercial banks and have served a different customer base. This is gradually changing in Bulgaria and worldwide. Commercial banks are beginning to find that well managed micro and SME loans can be profitable if properly structured, marketed and managed. Detailed, streamlined, and well-tailored policies and procedures and computerized systems management are key. From a marketing perspective, lending to this sector tends to develop strong community good will for a bank demonstrating a commitment to provide financial services to all residents within a community. Commercial banks with outside funding support are beginning to develop MFI and SME lending in Bulgaria. At least one of these programs (ProCredit Bank) is very aggressive and appears initially successful in its operations. Commercial banks are better suited to graduate micro enterprises to small business loans and to continue to develop their businesses than are MFIs. The CRS USTOI program, for example, has no place for borrowers to go as soon as they need a loan of BGL 3000 to continue their business growth.

Commercial banks are rarely pioneers and the micro and SME sector is no different. In Bulgaria, it has taken the BACB to show Bulgarian commercial banks that mortgage based products can be used for a variety of small business loans and financial services very profitably.

Most of the MFIs and NBFIs are operating legally, but their legal status is temporary and uncertain and functions without a statutory or regulatory framework that can ensure their legitimacy and long term ability to serve their customers. These institutions constitute only a small percentage of the total Bulgarian financial market but considering the nature of their portfolios their collective asset volume to date has been impressive.

The dominate legal and regulatory issue for the NBFIs is the issue of legal status and a need to determine the appropriate regulatory and supervisory structure that will best provide an adequate level of public confidence in NBFIs. Also, the types of banking services that NBFIs should be

[7] To a degree, the Ministry of Labor and Social Policy Social Fund Initiative being intermediated through UBB, Post Bank and Eurobank has targeted this gap with its microfinance program of loans from $5,000 to $15,000.

allowed to offer must also be determined. The objective of this effort will be to insure the safety and soundness of NBFI financial services, to maintain public confidence and to ensure the sustainability of the institutions' operations.

Historically, there have been several attempts to pass legislation or amend the Law on Banks to establish legal status for one group or another of the NBFI organizations. The purpose has been to:

- Establish or clarify their legal status either within the Law on Banks or in independent legislation;
- Enumerate their powers and authorities, including products and services that they may offer to the public or their members; and
- Establish a regulatory framework and supervisory structure that would provide prudential oversight over the institutions.

None of the proposals have enjoyed broad government and parliamentary support needed to enact revisions to the law. The BNB has opposed establishment of a full regulatory and supervisor system to be run by the BNB to examine a large number of NBFIs that would be typically small in total assets and have large numbers of small loans making up those small assets. Prudential oversight of such institutions would require a substantial commitment of BNB resources beyond what they could allocate to this activity and maintain their primary supervisory role of commercial banks. Any addition of regulatory responsibilities to the BNB without the resources to carry them out would not be responsible government.

Some officials view the very nature of most NBFIs being small and "credit" only does not pose a systemic risk to the Bulgarian banking system. That said, the view continues that requiring an extensive and potentially costly regulatory and supervisory function would be a waste of resources. What losses might occur from a failed NBFI would be limited to member losses or loss of donor funds and not important or harmful to the general public or the banking system. This view also presumes that deposit-taking authority to the public would not be authorized for any NBFI. . As a result, none of the NBFIs have received permanent legal status. Nor has the services they may provide been enumerated, nor has a supervisory and regulatory system been put in place dealing with this segment of the financial sector. There is a tacit belief that these institutions will fade away as their donors or benefactors decline to advance more funds.

V. Recommendations

A. Recommendation Number One: Provide Continuing Financial Support to Microfinance Programs or an Effective Workout

USAID should continue to provide financial support to these microfinance programs to allow them to become sustainable or until their loan portfolios are absorbed into a sustainable institution. These institutions already have a substantial numbers of customers who should not be suddenly left without alternative financial services. There is clearly sufficient loan demand. These institutions use methods and approaches which support, for the most part, safe and profitable lending. Based on the progress the three microfinance programs have realized in a period of less than three years, USAID should continue support them for a sufficient period, based on realistic program projections, to allow the programs to graduate to sustainability. Those institutions not able to achieve sustainable growth within this period should be encouraged and assisted to merge with other sustainable institutions, including commercial banks.

Budgetary constraints are often responsible for benign, but effective, termination of programs through no fault of the donor, their contractor, or the beneficiaries of the program. Effective extension of credit is one of the more powerful development engines that can dramatically affects people's lives and their welfare. Abruptly removing credit can have a dramatic and sometimes devastating impact on borrowers. Borrowers can find themselves in a worse position than they were before they received credit. This should be avoided if at all possible.

USAID should continue technical assistance and training support to demonstrate to other donors and lenders that growth of management expertise, board development, and maintenance of internal controls will continue. If USAID is unable to continue funding for all programs, then we recommend that it be concentrated on the best performing institution, which in the opinion of the Team is Nachala. Their policies, procedures, administration, breadth and depth of products and services, and financial performance recommend it over CRS and WOCCU.

If USAID funding is not available to continue any program, then USAID should assist the NGOs to obtain donor and debt funding from other sources or assist the consolidation of the portfolios. Alternatively, USAID should assist the programs to consolidate to develop a sustainable institution from the combined portfolios.

A central focus of this recommendation is that a responsible workout strategy should be developed and comprehensively implemented to enable the programs' customers to have a continuing source of reliable financing. These programs should not disappear as a multiyear experiment with no graduation, sustainability, or exit strategy.

B. Recommendation Number Two: Assist in the Establishment of the Legal and Regulatory Framework Necessary for Long-Term Sustainability

During the course of the Team assessment, a rationale for supporting establishment of a legal framework and regulatory and supervisory structure for NBFIs emerged. To be credible, the many concerns and issues raised by the interested ministries, council of ministers, parliament and the BNB will need to be fully addressed. Further, any regulatory approach will require that all NBFIs participate and support the proposed structure. These conditions will need to be satisfied to assure a reasonable opportunity for success of any legal and regulatory reform.

The appropriate approach for regulating NBFIs is through a nongovernmental regulator that all NBFIs must join. In order to demonstrate the low administrative cost that can be associated with effective, safe and sound regulation of NBFIs, it is recommended that a turnkey regulatory system for use by an NGO regulator be developed. The existing NBFIs are cooperating in moving toward the development of similar reporting and monitoring systems.

Using known regulatory and monitoring systems for each type of NBFI, it is possible to develop a comprehensive regulatory regime, including legislation, regulations, CAMEL and PEARL type systems, computerized monitoring systems, and computerized assessments and evaluations. Through development of a turnkey regulatory system tailored to each type of NBFI, the Ministries of Finance, Agriculture, Labor and Social Policy will be able to see how these institutions can be monitored, regulated and supervised efficiently and effectively. The demonstration of a regulatory structure will permit the BNB to determine that the NBFIs can be regulated and supervised properly and efficiently without an inappropriate burden being added to their role. This will increase the probability the BNB will support legislation to implement the regulatory regime recommended.

It would not be necessary to develop a regulatory scheme from scratch. Each of the existing NBFIs in Bulgaria have known regulatory, CAMEL, and monitoring systems to assess the institution's financial performance and to identify weaknesses in the institution's management and operations. Many firms and NGOs have worked with one or more of these NBFIs and are familiar with these regulatory tools.

For this reason, it is recommended that technical assistance be provided to the BNB or Ministry of Finance supported by an Intergovernmental Working Group[8] that involves all government and non-government parties interested in a legal and regulatory framework for NBFIs. The system developed should be inclusive of all types of non-bank entities in Bulgaria. The provider of technical assistance should work with these entities to develop a turnkey regulatory system tailored to support all NBFIs operating in Bulgaria. A successful use of this approach would be expected to result in legislation adopting the regulatory scheme that would meet the objectives of all the interested parties. This regulatory scheme would benefit the institutions and their customers, and free up valuable government resources from ministries that have allocated resources over the last several years to consider separate legislation for credit cooperatives, credit unions and other NBFIs.

To be responsive to the concerns of the interested government and non-government parties, a series of major issues will need to be fully addressed in the development of a regulatory framework for NBFIs. These are:

1. **Legal Framework**:

Banking legislation tends to be complex and require broad consensus within a government to be passed. It typically takes one-to-two full legislative cycles to pass any significant changes to existing law.

It is anticipated that the regulatory and supervision needs of NBFIs will be relatively straightforward and simple, thus the legislation should be equally simple. It is recommended that the Working Group should work toward a goal of developing a very short amendment to the Law on Banks to license and authorize non-bank institutions to undertake specified limited financial

[8] It is our understanding that the World Bank Social sector will require such a Working Group to look at a legal and regulatory framework for NBFIs. The approach suggested here could provide the professional expertise to that Working Group to facilitate a positive result.

services according to the new law. The legislative language should cover only essential issues for statutory authorization and oversight of the NBFIs. Details can be covered in the regulatory regime. Regulations are subject to easier review and change, which can be appropriately approved by the Cabinet of Ministers. During the development of legislation, it is suggested that attention be given to the NBFI provision of the banking acts of other European countries, as these items could become EU accession issues.

2. Regulatory regime:

A regulatory system will need to be developed in addition to a change in legislation. It should consist of rules tailored to each type of non-bank institution, whether it is a credit union, credit cooperative, MFI, or credit kasas. Subjects that should be addressed in regulation are:

- Capitalization;
- Ownership;
- Corporate governance;
- Financial service and authorities of the institutions; and
- Monitoring and reporting requirements, including format and electronic reporting.

A strong effort should be made to keep the regulations simple in structure, comprehensive and flexible. The NBFIs should have clearly spelled out limitations and restrictions concerning their corporate authority to undertake certain financial services. Each type of NBFI could have its financial service authorities enumerated in its charter upon demonstration of the operational and managerial capabilities to provide quality services and capital adequacy to sustain certain services.

The establishment of a regulatory regime before enabling legislation is passed will allow interested Ministries, the BNB, Parliament and the affected NBFIs to know from the beginning that the institutions would be safely and soundly regulated in an efficient manner.

3. Bank supervision and monitoring:

Certain elements must be provided as part of a turnkey regulatory system:

CAMEL: Camel-type systems are readily available for credit unions, credit cooperatives or MFIs, for assessing the relative institutional risk of each NBFI. These structures should be adapted for use in the NBFIs currently operating in Bulgaria.

Monitoring: The system should provide computerized monitoring systems that analyze an institution's financial performance based on reported data from call reports and monthly, quarterly, and annual financial statements. There are available software programs that could be used or easily adjusted to meet this requirement.

Performance ratios: Financial performance ratios are already known for each type of NBFI and should be tailored to the institutions in Bulgaria.

Reporting: Administrative costs can be minimized and timely assessments achieved through the use of electronic reporting via the Internet for evaluation and review.

The simple nature of NBFIs financial operations and use of off-the-shelf software and financial assessment templates should make assessments easier. Desk audits of each institution can be conducted annually with onsite examination at least once every three years, or even less frequently for some institutions, depending upon their activities. In the event that a desk audit indicates a financial weakness, immediate attention, expanded supervisory action, including on-site examination, can be ordered.

4. Capitalization:

Capitalization issues fall into two categories:

a. Long-Term Capital. What is the level of capital needed to support NBFI's more limited operations? This issue relates to the level of risk that the more limited and restricted NFBI has and whether it should warrant lower risk-weighted capital. Authorities are split on this issue. However, with Bulgaria looking to accede to the European Union, attention should be paid to the capitalization requirements for these types of institutions in other EU countries. Generally speaking, NBFIs have lower minimum capital requirements than commercial banks in EU countries.

b. Startup Minimum Capital. What is the minimum startup capitalization needed to permit a NBFI to begin operations? Member-owned organizations normally only lend their member's capital to borrowers until they have sufficient capital to support debt funding or deposit-taking. NGOs with microfinance programs usually lend donor funds and are supported by administrative subsidies during the startup phase. Consideration might be given to a lower tiered minimum capital for allowing such an institution to be chartered. The operations in such cases would be expected to be quite limited until the institution reaches the minimum capital for expanded services and operations.

5. NGO Regulator:

The key to minimizing administrative costs and avoiding strains on BNB resources is combining a non-governmental regulator with a pre-designed assessment systems. This is coupled with efficient oversight provided by people that best understand NBFIs and have the strongest incentive to assure their safe and sound operation. To be effective, all NFBIs should be required to join the NGO regulator as a member and pay for its operation through an assessment scaled according to their assets. Finally, the BNB should have ultimate authority to step in whenever it considers it necessary for safety and soundness reasons to take action regarding any NBFI.

This approach does not impact BNB or other government resources. In joining the NGO regulator, each institution agrees to be bound by the regulatory regime and decisions, including enforcement decisions of the NGO Commission. The NGO Commission should be composed of representatives from each type of NBFI, as well as a BNB representative, all appointed by the government for fixed terms. BNB representation should eliminate the need for greater BNB involvement, though the BNB could have as much oversight of the body's decision-making as it deemed appropriate.

Initially, the NGO regulator could be supported by the USAID financed technical assistance project until assessments from the NBFIs are sufficient to make it fully self-supporting. Long-term, the NGO regulator should be supported by assessments of the institutions it regulates.

It is envisioned that a small highly trained staff would use the CAMEL, monitoring, and analytical and diagnostic tools to examine the institutions and recommend supervisory actions, as necessary, to the NGO regulator. All enforcement actions would occur only upon the vote of the commission. Liquidations or forced merger of a failing institution would be ordered by the NGO regulator and could be confirmed by the BNB.

6. Liquidity or Guarantee Fund:

As a condition of authorization to take deposits, an NBFI should be required to demonstrate their ability to do so safely, secure them until their return is demanded, cash manage them properly, and have appropriate asset/liability management practices. As an additional requirement, no NBFI should be granted deposit-taking authority until there is sufficient capitalized liquidity or guarantee funds to cover deposits of institutions authorized to take deposits. Any institution seeking to take deposits and therefore, needing the guarantee would be required to pay insurance premiums into a fund to cover the risk of loss of their deposits. The liquidity fund should be managed by the NGO regulator according to strict investment policies.

7. Objective:

A primary objective of a USAID financed technical assistance project would be to demonstrate the regulatory and supervisory system on a representative group of each type of NBFIs. The NGO staff should conduct a desk audit and onsite examination of each selected NBFIs, using regulatory, examinations, and monitoring models established for each type of entity. The objective is to provide a clear demonstration of the effectiveness of the proposed regulatory scheme. Results from these actions should be presented to the NGO regulatory body, the BNB Bank Supervisory Staff, the Parliamentary Economic Commission, and other interested GOB officials of the Ministries of Finance, Agriculture, Labor and Social Policy. This action will facilitate the consideration and passage by Parliament of enabling legislation for the NBFI legal framework with the knowledge that a complete regulatory regime is ready to implement once the legislation has passed.

Annex A

Tables

Summary Tables of Information Drawn from Questionnaires Obtained from Non Bank Financial Institutions, Banks, and Borrowers

Table 2 Major Constraints to Increased Credit Access in Bulgaria (Respondents' views)	
Category	Constraints reported in order of frequency
Legal	• Lack of a legal and regulatory framework for the non-bank MFIs • No clear legal niche for microlending • Frequent changes in laws • Difficulty in realizing collateral • Other significant issues: Law on Special Pledges, court procedures, central credit register, corruption & permits, tax laws
Regulatory	• Lack of support for small business; heavy taxes, charges and patents; bureaucracy; licensing/permit regimes and corruption • Inconsistency in implementation of national regulations across localities • Lack of transparency • No supervisor of cooperative credit institutions
Operational (within institution)	• Banks are not equipped to handle microfinance • High unit cost of small loans
Operational (outside institution)	• Limited geographic scope of operations • Corruption
Source of Funds	• Insufficient capital for lenders active in microfinance • Reliance on donor funding • Shortage of long term deposits/funding sources for on lending
Stability of Investment Climate & Monetary System	• Frequent change of laws

Table 3 Respondents Opinion of the Percentage that Demand for Credit Exceeds Supply - Non-Bank Sector					
	0%	**25%**	**50%**	**75%**	**≥100%**
Non-Bank Category					
Loans No. & Percentage					
< $1,000 (USD) (6 & 28%)		1	2	1	2
$1,000 - 5,000 (5 & 24%)			1	3	1
$5,000 - 10,000 (6 & 28%)		3	1	1	1
> $10,000 (4 & 19%)	1	1	1		1
(21 & 100%)					
Pawn Shop Loans					
- Gold (2)	2				
- Non- gold (2)	2	1			
Vendor Credits					
- From Vendors (Supp (4)		1	2		1
- From Others (4)		1	2		1
Rotating Savings and Credit Assoc. (Mutual Kasas)(5)		1	2		2
Family and friends (5)		2	1		2
Production Loans (Commercial & Industrial) (5)			3	1	1
Other Loans (specify- leasing) (2)		2			
Agricultural Loans					
Production Loans (5)		1	1	2	1
Equipment Loans (5)	1		1	2	1
Land (Farm) Loans (4)		1	1		2
Other Agricultural Loans					
Other					
Residential Improvement Loans (4)	1	1		1	1
Financial Advisory Services (4)	3		2		
Government Credits					
- National (4)	2		1		1
- International (4)	1	1		1	1
Total W/O Financial Advisory Svc. (77)	10	17	19	12	19
Percent of Total	**13%**	**22%**	**25%**	**15%**	**25%**
% at or above each demand level		87%	65%	40%	25%

Table 4 Respondents Opinion of the Percentage that Demand for Credit Exceeds Supply - Bank Sector					
	0%	**25%**	**50%**	**75%**	**≥100%**
Bank Category					
Short Term (One year or less) (No.)					
Consumer Installment Loans (6)	1	2	1	1	1
Asset (Collateral) Loans (6)		2		3	1
Commodity (Collateral) Loans (4)		2	1		1
Working Capital Loans (6)		2	1	2	1
Line of Credit (overdraft) Loans (5)	1	1	1		2
Pawn Shop Loans					
- Gold (3)	3				
- Non-gold (2)	1		1		
Total Short Term (32)	**6**	**9**	**5**	**6**	**6**
Percentage (100)	**19%**	**27%**	**16%**	**19%**	**19%**
% at or above each demand level		81%	54%	38%	19%
Longer Term (Over one year) (No.)					
Real Estate Loans (6)		2	2		2
Land Loans (Without buildings) (5)	2		1		2
Home Improvement (4)	1		1		2
Equipment Leasing					
Production Loans					
- Commercial & Industrial (5)			2	1	2
- Agricultural (5)		1	1	1	2
Total Long Term (25)	**3**	**3**	**7**	**2**	**10**
Percentage (100)	**12%**	**12%**	**28%**	**8%**	**40%**
% At or above each demand level		88%	76%	48%	40%

Table 5 Respondents Opinion of the Percentage that Demand for New Products Exceeds Supply					
	0%	25%	50%	75%	≥100
Possible Donor Assisted Products (No.)					
Short Term (One year or less)					
Production Loans					
- Commercial & Industrial (6)	1		4		1
- Agricultural (6)	1	1	2	1	1
Longer Term (Over one year)					
Production Loans					
- Commercial & Industrial (6)			2	3	1
- Agricultural (6)		1	1	2	2
Equipment Loans (5)			2	2	1
Building Improvement					
- Residential (6)	1	2	1		2
- Commercial (6)		3	1		2
Real Estate Purchase (6)	1		3	1	1
Land Purchase (5)	1	1	1		2
Equipment Leasing (6)			4		2
Lease to Purchase Lease (5)	2		1		2
Leasehold Improvements (3)	1	1			1
Other					
Loan Products in General:					
- Targeted to Women (5)			3	1	1
-Targeted to Men (5)			3	1	1
Total (76)	**8**	**9**	**28**	**11**	**20**
Percentage (100)	**11%**	**12%**	**37%**	**14%**	**26%**
% At or above each demand level		89%	77%	40%	26%

Table 6 Issues related to Strengths and Weaknesses of USAID Funded NGO Lenders (Respondents Comments)			
Topic Area	**Nachala**	**CRS**	**WOCCU**
Sustainability			
Strengths	Constantly improving proportion incomes/expenditures	We have a realistic plan in place for achieving an operationally and financially sustainable institution.	100% dependence on local population for providing credit funds. Encouragement of savings behavior among local population.
Weaknesses	Opportunity for improvement depends on the presence of additional financial resources	Donor dependence.	Current lack of an adequate legislative, regulatory, and supervisory framework for cooperative credit institutions inhibits safe and sound growth and extended outreach in the form of increased provision of financial services by the existing institutions.
Governance			
Strengths	Board of Directors now consists of five responsible members working effectively to improve the Nachala program.	Within current legal environment, after much research and consultation, have worked out mechanisms for good governance.	Clients are owner-members of the institution. Each member has the right to one vote in the matters of the institution, regardless of the size of their investment. Cooperative financial institution owners have invested in the institution in order to benefit from its services.
Weaknesses	Two past Board members had to be replaced at the February 27, 2002 Extraordinary General Assembly, both for unwillingness to discharge Board responsibilities and one for unethical behavior.	Still at planning stage, need to identify and educate board members. Not yet ready to separate the institution.	Rich investors tend to prefer joint-stock governance since they have greater voting rights and control based on their larger investment in the institution. Borrower-dominated cooperatives may make decisions in favor of the borrower, thus, creating unfavorable conditions for savers and potentially endangering the general health of the loan portfolio.
Internal Controls			
Strengths	Management works with Board to insure proper controls, even to replacing Control Committee members when necessary.	Good internal control systems in place.	Member-elected internal supervisory board to monitor internal controls

Weaknesses	Two members of the Control Committee were unwilling to fully discharge their responsibilities and were replaced at the February General Assembly.	Need constant vigilance and development/transformation as we expand.	Volunteer supervisory board may lack expertise and independence in monitoring internal controls.
Products			
Strengths	High demand of individual loans, good terms, consultancy for preparation of business plans etc.	Cost efficient: allows making lowest size loans on the market while still achieving self-sufficiency. Easy, regular, consistent access to loans for micro-entrepreneurs.	Member-driven product and service delivery encouraged by member/owner participation in governance
Weaknesses	Amount of loan capital limits offering larger-amount and longer-period loans	Lack of diversity; Not as flexible as other loan products which creates the risk of "losing" our most mature clients to other institutions.	Limited number of products and lack of adequate marketing may inhibit provision of services to a larger group of potential members
Market position			
Strengths	Stable; good reputation	Niche market with lowest loans: loan access for the smallest businesses.	Employee kasas location in the workplace encourages efficient and convenient product delivery to employees. Cooperative and Employee kasas expertise and experience in serving the average Bulgarian and micro enterprise targets.
Weaknesses	Unable to cover the whole country due to lack of sufficient financial resources	Lack of diversity; Not as flexible as other loan products which creates the risk of "losing" our most mature clients to other institutions.	Small and mostly unknown to greater population due to limitations of employee common bond in the case of the Employee kasas. In the case of Cooperative kasas marketing of services is mainly though word of mouth since 1997 change in the Cooperative Act.

Table 7 Issues related to Opportunities and Threats of USAID Funded NGO Lenders (Respondents Comments)			
Topic OT	**Nachala**	**CRS**	**WOCCU**
Sustainability:			
Opportunities	To achieve long-term sustainability using additional financial resources	Sustained funding at current grant level from USAID will make the institution sustainable.	Promotion of existing self-funded, self-sustainable cooperative credit institutions. Increased safe and sound domestic financial intermediation.
Threats	Economic downturn would lead to deteriorating portfolio quality and adversely affect sustainability	Donor dependence.	Government might not provide policy framework to support a regulated and supervised cooperative credit institution sector. Government and international donor focus on credit-only, donor-dependent policy framework for microcredit delivery.
Governance: ***Opportunities***	Fully committed and active Board of Directors. Full support of Opportunity International.	Separate institution will gain strength by diversification of inputs and leadership through board.	Move toward EU Banking Directives and European models, which address many of the government's concerns about cooperative lending & deposits.
Threats	No perceived threats. The two replaced Board members impeded good governance but are no longer a threat.	Difficulty finding committed and capable board members	No provisions for cooperatives under the Bank Act, Little definition for cooperative financial institutions under the Cooperative Act.
Internal Controls: ***Opportunities***	There is now a strong and responsive Controlling Committee resulting from the replacement of the Chairman and Deputy Chairman during the General Assembly.		With potential legislative framework that includes external supervision, the elected Supervisory Board will be motivated to ensure adequate internal controls are observed
Threats	No current perceived threats. New Chairman and Deputy Chairman functioning effectively.	Failure to constantly adapt systems to changing needs.	Under present legislative framework, internal controls are overseen by a volunteer Supervisory Board.
Products: ***Opportunities***	Offering new micro-financing products	While we maintain our current core product, we have the opportunity to diversify products in response to client needs.	Proposed cooperative bank association could serve secondary role to market the brand name and standardized services of member cooperative credit institutions.

Threats	Inability to diversify the scope of services offered due to lack of additional capital;	Other financial institutions develop products which may attract more mature clients	Limited mobilization of member share products, which in turn limits the delivery of credit products.
Market Position: ***Opportunities***	Possibility to cover the whole country with micro-finance services	Vast need for micro loans. No competitors for this size loan.	Existing cooperative credit institutions numbering over 100,000 members. Existing cooperative credit institutions currently provide over US$15 million in microcredit. Market position could be increased by professional brand-name marketing of standardized services
Threats	Utilizing the opportunity is impossible with the current regulatory framework and lack of additional capital.	Loss of mature clients to other lending mechanisms.	Legislative regulatory, and supervisory changes required to expand and develop business.

Table 8 Percentage Operational and Financial Sustainability by Year for USAID Sponsored NGOs (*)								
Institution	12-31-01		12-31-02		12-31-03		12-31-04	
	Op.	Fin.	Op.	Fin.	Op.	Fin.	Op.	Fin.
Nachala	96	96	105	100	110	102	115	105
Ustoi/CRS	57	39	71	59	109	87	130	98
WOCCU/Kasas	230	118	241	139	240	135	235	130
* Note: all percentages are projected except 12-31-01, which is actual.								

Table 9 Relative Demand by Target Groups on a Regional Basis (1)						
Borrowers by Target Groups	North Western Region	North Central Region	North Eastern Region	South Eastern Region	South Central Region	South Western Region
1.a. Market/Trade (Retail)	7	7	9	8	7	9
b. Supplier (Production)	9	7	9	8	7	9
2.a. Commercial (Retail)	7	7	9	9	7	9
b. Supplier (Production)	9	7	9	9	7	9
3.a. Food (Retail)	7	7	7	7	7	8
b. Supplier (Production)	9	7	7	7	7	8
4.a. Services (Retail & Production	9	7	7	7	7	8

Frequency and percentage for the occurrence of each ranking No. in Table 9					
Ranking No.	6	7	8	9	10
Frequency	0	23	5	14	0
Percentage	0	55%	12%	33%	0

(1.) Note: Based on respondents opinions ranking numbers were utilized to indicate a relative amount of additional demand by Region. The ranking number was derived from the average additional credit demand respondents indicated by region. The ranking was based on a scale of 1-10. Since no averages fell below 50% additional demand all indicators fell in the top half of the scale.

6 = 50-60% increase
7 = 60-70% increase
8 = 70-80% increase
9 = 80-90% increase
10 = > 90% increase

Table 10 Lending & Financial Factors, Risk Management by Non-Banks					
Characteristics Of a Loan as of 12-31-01	CRS/Ustoi	Nachala	WOCCU/ BULGARIA	Resource Center Foundation	Credit Commission (SDC)
A. Largest Loan in $	$1350	20 000	$23,000	$10,000	40 000
Smallest Loan in $	$275	300	$28	$1,000	3 000
Average Amount of Loan in $	$502	1 925	$555	$4,900	
B. Longest Loan Maturity, Mo.	8	24	36months	36	60 mo.
Shortest Loan Maturity, Mo.	4	3	2 months	12	24 mo.
Average Loan Maturity, Mo.	6	10.6	12mo.	15	
C. Highest Interest Rate by %	2%/mo.	17	45%	16	OLP +7%
Lowest Interest Rate by %	2%/mo.	14	6.15%	16	N/a
Average Interest Rate by %	2%/mo.	16	29.18%	16	N/a
D. Credit Criteria & Guidelines In Place (Yes or No)	Yes	Yes	Yes	Yes	Yes
E. Credit Application on File (Yes or No)	Yes	Yes	Yes	Yes	Yes
F. Current Loan Documents on File (Yes or No)	Yes	Yes	Yes	Yes	Yes
G. Current Loan Supervision Reports on File (Yes or No)	Yes	Yes	No	Yes	Yes
H. Current Income & Cash Flow Statements on File (Yes/No)	Yes	Yes	Yes	Yes	Yes
I. Internal Portfolio Information System (MIS) in Place (Yes/No)	Yes	Yes	Yes	Yes	Yes
J. No. of Different Types of Loans in Portfolio	1	6	8	3	1
K. Portfolio in Risk (>30days)					
---% by Loans	0	3.80%	N/R		0
---% by $ Value	0	3.86%	8.05%	1%	

Annex B

Contact List

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(* = Did not attend Participatory Session)

Microfinance Program Borrowers Interviewed, February 2002

Plovdiv

Name: Lalka Ilieva
Company: ET "Simona"
Business: Distribution of eggs
Lender: Nachala

Name: Nedelcho Iliev
Company: ET "Delimax"
Business: aquarium equip.manufacturing and distribution, food supplies
Lender: Nachala

Name: Marina Kuntcheva
Company: ET "Kuntcho Kuntchev"
Business: mini food store
Lender: Nachala

Name: Petko Manolov
Business: production and distribution of greenhouse vegetables
Lender: Nachala

Stara Zagora

Name: Konstantina Ivanova
Company: ET "Konstantina Ivanova - KOSI"
Business: contract sewing (ladies' clothing)
Lender: Nachala

Name: Maria Nikolova
Company: ET "Maria Nikolova"
Business: retail
Lender: CRS - USTOI

Name: Elena Georgieva
Company: ET "PINKO - 67"
Business: retail baby accessories
Lender: CRS – USTOI

Name: Semo Andreev
Company: ET "Ana Maria"
Business: market retail of sports goods
Lender: CRS - USTOI

Name: Venka Bogdanova
Business: kasa
Lender: WOCCU

Name: Ginka Vassileva
Business: kasa
Lender: WOCCU

Name: Maria Dontcheva
Business: kasa
Lender: WOCCU

Name: Radka Tchobanova
Business: kasa
Lender: WOCCU

Pleven

Group Name: Sun
Representative: Penka Iontcheva
Business: retail vegetables and fruits
Lender: CRS – USTOI

Group Name: Sun
Representative: Luisa Petrova
Business: canteen
Lender: CRS - USTOI

Name: Bozhidar Boyadjiev
Company: ET "Bozhidar Boyadjiev"
Business: production and sale of fish accessories
Lender: Nachala

Name: Georgi Tashev
Business: ET "Tashev"
Business: production of tourist rucksacks
Lender: Nachala

Annex C

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Annex D

Representative Case Studies

Eggs Retail and Wholesale

Borrower: Lalka Ilieva
Loaner: Nachala (Plovdiv)

Lalka Ilieva is an ambitious young lady, university graduate in engineering and in economics. After the economic and political changes in the country, she started her own business (in 1997) – trading with eggs. At the very beginning she used her personal automobile "Moskvich".
Svetlana Ralova told her about "Nachala" and what they are doing.
She decided to apply for her first loan (for the BGL equivalent to USD 1 200) with the purpose of buying greater quantities of eggs. She started offering eggs to the grocery stores in Plovdiv at lower prices.

After the repayment of her first loan, she got more self-confident, and applied for a second loan (for the BGL equivalent to USD 2 500). She used the funds to purchase a van. With her own funds, she purchased two more vans (second-hand). This led to creating three new jobs.
She created a network for supplying the grocery stores with eggs.

Thanks to her positive attitude to the clients, she broadened the network of grocery stores she works with, as well as her turnover. Within a year she managed to repay her second loan and applied for a third one (for the BGL equivalent to USD 8 000). With the funds she constructed two refrigerating storages and thus created 5 more jobs.

At present, Lalka Ilieva is one of the largest suppliers of eggs for Plovdiv and the near-by villages. Thanks to her correctness, loyalty and respect to clients, and mostly due to Nachala support, she grew her business.

Lalka Ilieva confirmed her willingness to work with Nachala in the future and thus create new jobs and grow her business. She says: There are no other organizations like Nachala that help young people establish and grow their own business in the country

Manufacture of tourist rucksacks

Borrower: TASHEV (Georgi Tashav)
Loaner: Nachala (Pleven)

Georgi Tashev is an alpinist and speleologist. He participated in numerous national and international expeditions. He was one of the members of the first foreign group that explored caves in Albania.

Before 1989, it was very difficult to buy professional equipment in Bulgaria, and even more difficult on the external markets.

That is how Georgi Tashev decided to sew for himself the appropriate rucksack. He used two sacks he had bought, and with his own sewing machine SINGER (inherited from his grandmother), he sewed his first rucksack. His friends and colleagues asked him to sew rucksacks for them also. Other people heard the news, and started ordering. He met his wife, when she ordered a rucksack.

In late 1996 Tashevs visited Nachala's office. At that time they already had 2 professional sewing machines, for the two of them, and worked in their basement. Nachala approved a loan for buying more sewing machines (amounting USD 3 000). Being in constant contact with Nachala, they noticed in their office an advertisement for competition: "Most Entrepreneurial Young Businessman" organized by the Bulgarian American Enterprise Fund (BAEF). Tashevs decided to participate and submitted their business plan. They were awarded second prize – USD 2 5000, which helped them grow their business.

In late 1997 Nachala approved a loan (USD 3 000) for the purpose of buying materials, and in 1998 – a loan (USD 6 000) for buying a machine (band-saw). At that time they employed 10 persons, and rented large premises. They opened a company store.

The family makes a great team: Georgi designs the rucksacks and repairs the machines, and Gergana communicates with personnel, suppliers and clients.

In November 2000 Tashevs had an opportunity to purchase appropriate building. Nachala approved a loan (USD 10 000) to cover the first installment

At present, TASHEV use that building and employ 18 young people. Their products enjoy great demand in the country.

Annex E:

Terms of Reference[9]

Bulgaria Microfinance Assessment

1. INTRODUCTION

The objective of this assessment is to provide USAID/Bulgaria with an overview of the existing Micro-Finance environment in Bulgaria by focusing on some specific areas as described later in the document.

This assessment is expected to provide USAID/Bulgaria with a summary of the existing microfinance environment in Bulgaria and deliver a set of recommendations on possible future undertakings. The results of this assessment will feed into the new strategy formulation and implementation process but will not itself constitute activity design or decision-making document.

USAID/Bulgaria is undertaking a comprehensive analysis of the appropriateness and value of various forms of micro-finance in Bulgaria. The study team will perform an overall assessment on the impact of various micro-lending activities and will propose specific recommendations for future programming. The purpose is to document and validate the needs and impacts of microfinance in the country, provide conclusions about the results achieved thus far, and offer recommendations for future implementation.

2. BACKGROUND

In September 1999, USAID/Bulgaria initiated a package of three micro-finance activities as an immediate response to the Kosovo crisis. The rationale for starting micro-finance activities was to sustainably increase income and employment among low-income groups and communities throughout Bulgaria, with particular focus in the Danube River region - one of the most affected regions in the country. Micro-credit programs were oriented toward increasing the number of micro-business entrepreneurs and providing additional support and better access to alternative financial services for micro and small size enterprises (SME) in the country.

Further details about the programs and their operations, including brief project descriptions and copies of the most recent quarterly reports for each of the activities will be provided as supplementary information.

3. OBJECTIVES OF THE ASSESSMENT

[9] These terms of reference were amended in the field to allow The Peoples Group Ltd to provide the final report in an Acrobat .pdf file in electronic form and on CD-ROM compact disc. In addition, the regional comparison of the MFI environment in Bulgaria with Croatia, Bosnia and Herzegovina, and Poland was to be limited to available materials provided by USAID. Finally, references reviewed are set forth in a separate disk.

3.1 OVERALL OBJECTIVE

The overall objective of this assessment is to weigh up the applicability of various micro-lending activities in the context of the Bulgarian environment. Also, it will equip USAID/Bulgaria with concise information and knowledge about most current trends and prospects for future programming. The goal of this assessment is to present a detailed overview of the existing Micro-Finance activities in Bulgaria by focusing on some specific areas such as Micro Finance Institutions' (MFI) legal status, target groups, outreach, risk-management, loan-size, interest rate structuring, etc.

3.2 PROJECT PURPOSE (SPECIFIC OBJECTIVES)

The specific objectives of the assessment are to:

1. Assess the needs and relevance of micro-finance provision in the current economic environment;

2. Examine the results of different micro-finance activities (other donor programs included), commenting specifically on loan servicing, delinquency rates, sustainability of beneficiaries/borrowers, and the sustainability of the means/methods of the various micro-finance models themselves;

3. Assess the ability of micro-finance to produce sustainable income and create employment generation;

4. Consider various types and methodologies for micro-finance provision and present an overview and recommendations for the most appropriate approach comparing different methods and building upon the experience and lessons learned from the region;

4. STATEMENT OF WORK

The assessment will be carried out in country and will include such methods, as the contractor deems necessary to perform the tasks under the subject Terms of Reference, and in accordance with the country specific circumstances. The contractor will be expected to coordinate with the Mission's ERGO team and other implementing partners to the extent possible.

4.1 General Areas of Concern

The team will be expected to:

- Provide comprehensive study and analysis on the current state of micro-finance operations in Bulgaria focusing on three major areas: (1) micro-lending sector infrastructure and institutional setting; (2) economic factors and indicators affecting the sector; (3) government policies in effect regulating MFI's operations;

- Assess the existing needs and projected demand and supply chains for micro-finance provision and develop recommendations for future programming. The assessment should include examination of the relevance and the role of micro-finance in advanced transitioned economies, from comparative perspective;
- Provide comparative status analysis of the micro-finance environment in Bulgaria comparative to conditions in other transitional countries -- for example Poland, Bosnia and Herzegovina, Croatia;

4.2 Specific Areas of Concern

The contractor should pay special attention to the following development concerns:

Lending and financial issues

Target groups of borrowers - in essence, the assessment team will look at whether the current loan recipients are those most likely to ensure that micro-lending objectives are achieved and lead to sustainability. The team will consider and provide comparative analysis on the appropriateness of group lending vs. individual lending (history, environment, and legal context) and make recommendations accordingly. The team will assess the borrowers to date and determine whether continued focus on those clients will best achieve the objectives determined for micro-credit programs, notably sustainability and preparation of borrowers and their enterprises to produce for domestic consumption or export, and to sustain the competitive pressures of EU accession. The team will recommend alternative target groups and management practices that could improve performance and lead toward achieving program targets. The team will look at relationship between loan size and borrowers' profiles, especially micro and small sized enterprises (SME) and target industry sectors. The team will consider the correlation between the loan size and borrower's profile and suggest any management practices that may be recommended.

Regional outreach - the assessment team will look at the geographic coverage of the existing programs and make recommendations on the potential for further expanding the programs' coverage and outreach.

Competitiveness and diversification of credit products and providers - the assessment team will examine the interest scale and the capacity of the local banks to provide micro-credit to the targeted borrowers' base.

Risk-management - the assessment team will analyze profitability/delinquency ratios of existing MF programs. In addition, the team will assess the potential impact of expanding the outreach (number of borrowers) and/or modifying the size of individual loans.

Loan-size - the team will assess the impact of the current loan-size offered to borrowers on the achievement of program objectives, on program administration, on sustainability and on credit risk. The team will also recommend appropriate loan size and program concentration.

Interest rate structuring - the team will assess the current interest rate scale with at least the following considerations: (a) rates for similar loans offered by other financial institutions; (b) market/commercial interest rates as best as these can be determined; (c) adequacy in covering risk (including possible devaluation and conversion difficulties); and (d) ability of target borrowers to pay (i.e., impact on margins and profitability). The team will explore options and management practices that could better position interest rate balance.

Legal issues

MFI's legal status - Assess the adequacy of MFIs registration, the legal rights, and the role this status is expected to play in the management of the micro-credit programs. Recommendations shall be made accordingly. The legal review will cover rights, responsibilities, tax environment, ability to maintain regional presence and registration requirement for regional branches, banking operations, etc.

Legislative framework - The team will assess the existing legal framework and will provide recommendation for further improvement.

5. TIMING AND WORK LOCALE

The final assessment report, including all supporting data and documentation shall be submitted to USAID/Bulgaria no later than March 15, 2002.

The team leader will have 3 days prior to arrival in the country for work in the US. He/She should get acquainted with relevant written materials about Bulgaria meet and interview people and other donors who have knowledge about the country specifics.

It is assumed that the assessment team will assemble in Sofia, spend time on orientation, team building and internal organization, and complete its field visits/data collection approximately for two weeks. This will allow also approximately four days for writing up draft results and recommendations.

It is expected that the assessment team of experts will perform most of its work and analysis in Bulgaria. Work should commence in February 2002.

6. DELIVERABLES

The team will complete a report containing an executive summary, overview, analysis, and recommendations (with rationales) in the micro-finance sector. A presentation to key USAID staff and draft report will be provided to the Mission prior to the team's departure from Bulgaria. Final version of the report in electronic form (software application compatible with MS Office

97) and five paper copies must be delivered to Nikolay Yarmov at USAID/Bulgaria in Sofia within 10 working days after the submission of USAID/Bulgaria comments.

All detailed analyses and supporting documentation will be provided as annexes. At least one copy of all key references and supporting documentation will also be provided with the final report.

Experts provided under this Purchase Order would have the primary responsibility for conducting the analysis and writing the assessment. Staff from USAID/Bulgaria may participate in some or all aspects of the assessment, but should not be expected to take responsibility for completing sections of the assessment.

7. RELATIONSHIPS AND RESPONSIBILITIES

The contractor will report directly to Nikolay Yarmov, Senior SME Advisor as the main liaison for USAID/Bulgaria and/or Mr. Edward LaFarge, Private Enterprise Officer.
Designated USAID/Bulgaria staff will review all reports and appointments as necessary.

8. SPECIAL PROVISIONS

Languages - All reports by the Contractor shall be submitted the English.

9. STAFFING

The services of two international experts – team leader and consultant will be required to carry out this assessment.

It is suggested that international experts will be teamed with local experts (1-2) with parallel but complementary professional expertise. Bulgarian professional members would also ensure that there are no problems in dealing with local language interviews, data and research materials.

Minimum skills and qualifications required.

Each of the experts undertaking this assessment will have advanced degrees in appropriate fields and 5 – 10 years of experience in their professional field. It is preferred that the international experts have experience in Bulgaria and/or Central and Eastern Europe.

Annex F:

Assessment Team Objectives, Methodology and Team Composition

Assessment Objectives and Specific Areas of Concern

The overall objective was to assess the applicability of various microlending activities in the context of the Bulgarian environment. Also, it was to equip USAID/Bulgaria with concise information and knowledge about most current trends and prospects for future programming. The goal of this assessment was to present a detailed overview of the existing microfinance activities in Bulgaria by focusing on some specific areas such as Micro Finance Institutions' (MFI) legal status, target groups, outreach, risk-management, loan-size, interest rate structuring, etc.

The specific objectives of the assessment were to:

- Assess the needs and relevance of micro-finance provision in the current economic environment;
- Examine the results of different micro-finance activities (other donor programs included), commenting specifically on loan servicing, delinquency rates, sustainability of beneficiaries/borrowers, and the sustainability of the means/methods of the various micro-finance models themselves;
- Assess the ability of micro-finance to produce sustainable income and create employment generation;
- Consider various types and methodologies for micro-finance provision and present an overview and recommendations for the most appropriate approach comparing different methods and building upon the experience and lessons learned from the region;

The contractor was asked to pay special attention to a series of development concerns.

Assessment Methodology

The Peoples Group Team began by reviewing the literature provided by USAID to gain an overview of the situation in Bulgaria. Next, they met with USAID's Economic Restructuring Team to obtain a further overview and recommendations regarding key individuals and institutions to contact in Bulgaria. Based on these initial steps, a work plan was developed. The plan included:

- Design and distribution of questionnaires to 8 key individuals and another 8 related
- Design and distribution of questionnaires to 8 key individuals and another 8 related individuals identified by USAID;

- Interviews with recommended personnel from intermediary finance organizations and other institutions related to the business, legal and regulatory environment;
- Site visits to three, diverse geographic areas (Plovdiv, Stara Zogora & Pleven) to obtain a realistic view from the field of the institutions and their borrowers;
- Interviews with sixteen borrowers during the three site visits;
- A participatory session with the primary participating individuals in the assessment.

Consistent with the work plan, the Team interviewed key persons from all financial service providers funded by USAID. In each case, this included the head of the technical assistance team supporting the service provider. Additionally, the Team interviewed key persons engaged in small and micro credit activities that were not funded by USAID. A total of 10 key persons were interviewed. Examples of persons outside of USAID funded providers included, ProCredit Bank and the Executive Director of Resource Center Foundation. Examples of key persons interviewed from USAID-funded projects, included the CEO of Nachala and managers of individual branch offices. The topics covered during the interviews included an overview of the credit situation in Bulgaria, constraints encountered by the financial service provider, types of credit products provided, prospects for new types of credit products, geographic differences in credit demand, and operational and financial sustainability. The key person interviews were followed by interviews with borrowers.

In addition to the interviews, 10 completed questionnaires were received and included in the analysis. The questionnaire was designed to elicit responses from key individuals and organizations identified by the Mission with respect to the major issues identified in the Terms of Reference.

The Team used the results of the questionnaires and individual interviews, along with the review of documents, reports and other existing literature, in preparing this report. Lists of person's interviewed/visited, the reports and publications reviewed are provided in Annex B and C.

Assessment Team Composition and USAID Briefings

The Peoples Group, Ltd, conducted the evaluation in Bulgaria during the period February 18 through March 6, 2002. Under Purchase Order (PO183-2002-026), dated February 4, 2002 and executed on February 7, 2002 by Kenneth Peoples as Chairman. The team consisted of three finance experts: Frank Naylor Served as Team Leader. He was assisted by Ronald Bielen and Marshall Burkes. The Team provided a debriefing to NikolayYarmov, Senior Advisor: Enterprise Development, David Lieberman, Chief, Private Sector and Edward LaFarge, Private Sector of USAID/Bulgaria, prior to departure from Bulgaria.